



## Feasibility of Bay Salam Finance: A Survey of The Opinions of Stakeholders

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**Abstract:** The present study aims to explore the potential application of Bai Salam (forward sale agreement) as substitute financial instrument in the agriculture sector of Pakistan. The conclusion is drawn through a survey questionnaire from 300 farmers and bankers in a district of Punjab. For analysis, we use SPSS software and presented the results by using descriptive methods. This study overall concludes the banker's and farmer's awareness, willingness, risks, hurdles and the role of institutions in the Salam promotion. The majority of the farmers are not aware of the Salam contract because the Islamic bank's branch network is limited to urban areas and there is no proper promotion campaign launched by the Islamic banks for awareness about Salam among the farmers. Bankers are reluctant to finance the tenants, orchards due to more operational risk for the bank. Bankers opinion that small farmers do not have personal securities which is not a solid reason because half of the sampled farmers take a loan from the formal system if they can provide securities to conventional interest-based institution why they can't provide securities to Islamic financial institutions? There is a vast market for the Islamic Banks if they sincerely pay their attention towards forward sale contracts. The concept applies to all areas of agriculture and livestock farming to overcome financing problems and boost production.

**Keywords:** Islam, Banking, Agriculture, Pakistan.

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### Introduction

The financial sector is considered as a backbone of the modern-day economy, for the provision of capital, job creation, and overall prosperity (Cogan, 2008). Regular access to credit is considered pivotal to reduce poverty in an agrarian society. Easy access to credit not only helps to get the better overall productivity of the farmers but also improves social indicators in the long run (publications, 2008). Despite all economic benefits, agriculture financing is widely perceived as risky and low returns along with other reasons mainly due to unpredictable weather conditions and high default ratios. The same impression may also be true in Pakistan; commercial banks disbursed only 3.5 percent of the total loans in the rural areas by the end of 2002 (Pakistan G. o., 2003). Banking sector's disbursement to agriculture is only 6 percent of their total financing (Pakistan S. B., Handbook on Best Practices in Agri/Rural Finance, 2011). The figures highlight the need to guarantee regular transfer of funds to rural areas to diminish poverty levels and to generate economic activities for the farmers.

Conventional financing is interest based and has worst effects on the economy. Interest squeezes the economic activities in society and creates a gap between the different segments. As

a result, the rich become richer and poor becomes poorer. An alternate mode of financing in Islam (Shari'ah) is Bay Al- Salam.<sup>1</sup>This research will explore the possibilities of agriculture financing under the concept of Bay Al-Salam (forward sale contract) in Pakistan. Bay Al-Salam is a trading contract rather than an interest-based loan. It is encouraged as an acceptable Islamic mode of financing. The efforts to initiate agriculture financing under Islamic banking concept Bay Al-Salam is not new in Pakistan. Interest-free loans to the farmers were first time introduced in 1979 against two personal guarantees. The State Bank of Pakistan (SBP) paid accrued interest directly to the commercial banks. It is important to mention that the share of interest-free loans augmented from 30 percent of the total agriculture financing in 1984 to 50 percent in 1985 before it was withdrawn in July 1988 due to large-scale maltreatment of funds through proxy loaning, family loaning, and paper loaning. Since then, no financial institution in the country offered agriculture financing under Islamic banking concept. The SBP, in February 2009, issued new guidelines for the commercial banks to initiate Islamic financial products in the agriculture sector. These guidelines identify the Bay Al-Salam contracts as an option to provide working capital to the farmers. Punjab Provincial Assembly in April 2011 approved an Act No. PAP/legis-1(23)/2008/378 sitting of the assembly held on January 19, 2011, which was about the introduction of Islamic financial system, aimed at bringing reforms in Agro-economy in Punjab. Financing under Bay Al-Salam contracts represents RS. 2.7 billion, 1.4% share of the total financing at the end of December 2010 and at the end of March 2013, it increased to RS. 13 billion, 5.2% share of the total Islamic banking (Pakistan S. B., 2013).

In Bay Al-Salam, the buyer enters into a future contract after paying 100 percent price in advance to the seller. The contract has further advantages in agriculture as compared to other modes of Islamic financings such as Profit and Loss Sharing (PLS) and *Bay Al-Muajjal* (sale on deferred payments). The PLS idea involves a large amount of work in determining the proper and achievable PLS ratio. Similarly, *Bay Al- Muajjal* is the reverse of Bay Al-Salam whereby only the available crops are purchased while the payments are to be made to the farmers at future dates. In Bay Al-Salam, the farmers get the benefit that he does not have to search the market for his products. On the other hand, the financial institution can be confident to buy a product at competitive rates. Therefore, the risk on behalf of producer and buyer decreases. Farmers in developing countries are less educated and financially weak, they stay away from these types of financial tools. They consider such contracts as means of exploitation from middle-men.

*Bay Al-Salam* sale contract, in fact, is one of the neglected modes of finance among the practiced modes in the commercial and financial institutions, although it was permitted by the holy prophet Muhammad (peace be upon him) and practiced during the life of prophet (peace be upon him) as a means of economic development (Ayyash, 2008). The recent theoretical studies on *Bay Al-Salam* contract as compared to other Islamic financing techniques are quite limited in number. They are generally academic in nature and do not have any relevance to the modern financial and economic issues and problems. There are many commercial and financial issues of *Salam* which are still unattended and unexplored. This study recommends to Islamic financial institutions to make effective use of *Bay Al-Salam* contract and utilize it in their commercial and financial businesses to replace non-Islamic components of the modern commodity future trading in the financial markets. This study is oriented in general towards stimulating the financial markets as multi-functional institutions which can provide economic benefits at individual and societal levels. The practice of *Bay Al-Salam* sale contract as a pure Islamic alternative mode of finance can help us to overcome many complicated issues in mainstream financial market activities. The heavy reliance on controversial modes of financing such as *Tawarruq*, *Bay ul Innah*, and *Commodity Murabaha* by some Islamic banks in the Muslim world has badly affected the authenticity and originality of Islamic finance and affected its image. Islamic

<sup>1</sup> قال رسول الله صلى الله عليه وسلم "من أسلف في شيء ففي كيل معلوم ووزن معلوم، إلى أجل معلوم"

Shari'ah is irreconcilable with fake economic and financial innovations. This study will enable those who are working on converting the banking system to Riba free system to assess the feasibility of Salam worldwide concerning the mentioned criteria.

### Research Methodology

This study comprises on field research, and the main components of this research are to survey the market that might be the target of *Salam* finance experiment and survey the opinion/awareness of farmers regarding *Salam* finance. Two questionnaires are designed for bankers and farmers keeping in view the objectives of the research. Hence, it is based on qualitative and quantitative methods.

### Sample Selection

For a sample selection in district Toba Tek Singh, there are 3 Tehsils named KAMALIA, GOJRA, and TOBA TEK SINGH and having total 82 union councils (UC,s) 26, 24, and 32 respectively. We surveyed the Tehsil Gojra, In Tehsil Gojra there are 6 urban and 18 rural union councils. Out of these 18 rural union councils at random we selected 5 UC's from each UC selected at random 5 villages and from each village at random 12 farmers interviewed. We surveyed total 300 farmers out of these 300 questionnaires 280 were useable.

Banker's opinion collected via open-ended and closed-ended questions. Islamic banks and standalone branches situated in Islamabad were our populations, and at random 15 banks, we selected as a sample for the survey and a comprehensive questionnaire distributed among the bankers to check the bankers' awareness and also their point of view about *Salam* finance.

### Research Instrument

To collect the data from both samples, we designed two separate questionnaires which cover all the objectives. A first questionnaire designed for bankers in which some questions were open-ended and the remaining were close-ended, in close-ended questions respondent only mark tick in front of the answered. Bankers' questionnaire covers the main variables, awareness, risk, the role of the institution. The second questionnaire was for farmers, for farmers we translate the English questionnaire in Urdu because mostly the farmers have low education and they can't easily understand the English. At the time of translation, we consult different experts if there is any ambiguity or mistake can be removed. A farmer's questionnaire designed in a way that it covered all the questions related to farmers. The farmers' questionnaire covers the variables market portfolio, awareness, willingness, hurdles and role of the institution.



This question might take place in your mind that why did we take the bankers and farmer's point of view from two different cities? Because Islamabad is a metropolitan city and most of the Islamic banks are located here while in study area there is only one branch of Meezan bank is working the other reason is that Islamabad is Non-agricultural that's why we took the farmers' point of view from Tehsil Gojra to make the discussion more realistic and reliable.

### ***Analytical tools***

For analysis, we used SPSS software and presented the results by using descriptive methods like graphs, charts, and tables, etc.

### **Results and Discussions**

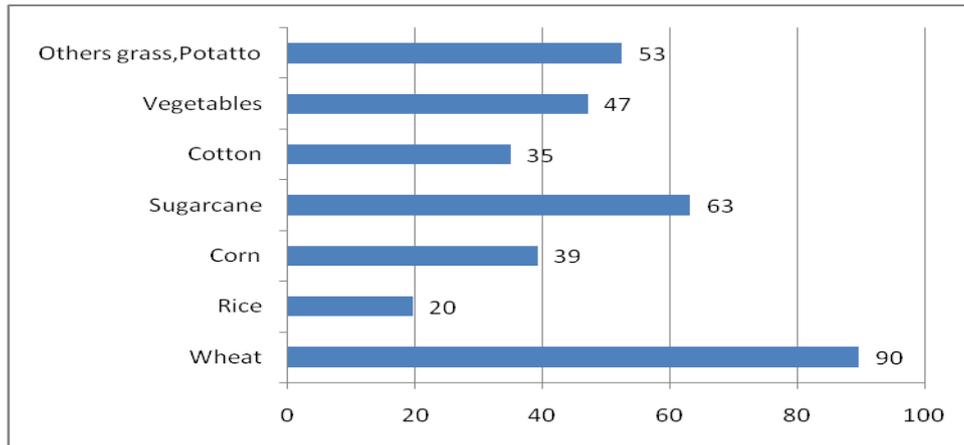
The results of this study are comprised of farmer's opinion and their perception about *Bay Al-Salam* and Banker point of view about *Bay Al-Salam*.

#### ***Market***

Pakistan is an agriculture country 40% of its population is directly dependent on agriculture for livelihood, and 60% are directly and indirectly linked to this profession. This main sector faces a lot of problems like unavailability of water, fertilizer and seeds, credit constraints, and lack of technology, etc. For exploring the feasibility of *Salam* financing, the questions that come to mind regarding the market for *Salam* finance. What are the crops that need financing through *Salam*? Is the target community aware of *Salam* finance? Do they get financing from any other source? In the following section, we try to answer similar questions. Besides the answers to above questions, the main contribution of this study is to survey what are the opportunities for *Bay Al-Salam* and what are hurdles in the implementation. The opinion and perception of Bankers, farmers, were collected through a structured questionnaire, the results of this survey are analyzed asunder. In the survey area, the composition of crops grown by the farmers is as follows.

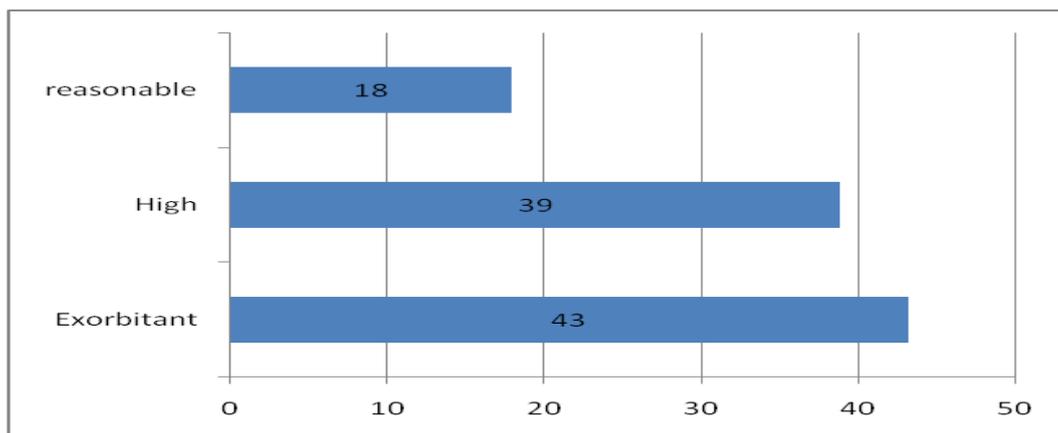
#### ***Crops***

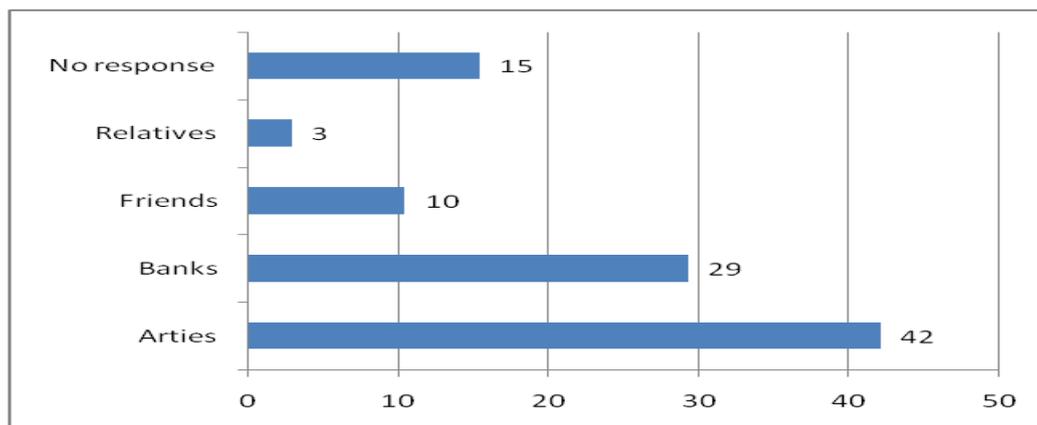
Most people cultivate Wheat, Sugarcane, Vegetables, Corn, Cotton and in other crops Potato, Canola, and fodder. A few percent people cultivate Rice. Figure 1 shows that in 2013, 90% respondent cultivated Wheat, 63% Sugarcane, 53% Potato Canola and fodder, 47% Vegetables, 39% Corn and 35% Cotton, but only 20% cultivated Rice. We can see in figure 1 most of the crops listed here are those which are highly demanded in the market and the bank will have no difficulties in it if purchase these crops through *Bay Al-Salam* contract.

**Figure 1. Crops Cultivated in A Year in Surveyed Area**

In rural areas, most of the people stay away from financial institution due to the element of interest because interest is prohibited and the second reason is the bank charge high-interest rate. Most of the farmers said once anybody gets a loan from a bank, it's very tough to set off the loan because of bank charge compound interest.

In response to a question that what is your point of view about the interest rate charged on agriculture loans by the banks 43% respondents said interest charged on an agriculture loan is exorbitant, 39% said high, and only 18% said the interest charge on agriculture loan by the bank is reasonable. Respondents also said that lending institutions exploit the farmers 42% said Aarhties (Brokers) exploit the more as compared to the bank. 29% respondents were those who take the credit from Aarhties/commission agents beyond the formal credit system. Normally, Aarhties provide the inputs to the farmers and set off the credit amount of the inputs at the time of harvest and the farmers are bound to bring their outputs to their shop. Aarhties earn dually first at the time of inputs, provide the inputs at a high price as compared to market second at the time of harvest when farmers bring the outputs, purchase at lower than the prevailing market price.

**Figure 2. Interest Charged by The Bank**

**Figure 3. Response Who Exploit More***Customer's Categorization*

State bank of Pakistan categorizes the land holdings into three broad categories. (a) Subsistence holding (b) Economic holding (c) Above economic holding.<sup>2</sup> In Punjab those farmers who have up to 12.5 Acres land lies under the category of subsistence holding, those who have land more than 12.5 Acres but less than 50 Acres are under the category of economic holding, and those farmers who own more than 50 Acres are above economic holding. Table 7 shows that in survey area 65% farmers are subsistence holding, 32.9% farmers are Economic holding, and only 2.1% farmers are above economic holdings. Subsistence holding count to 65% and this category mostly faces credit constraints; there is a great opportunity for Islamic banks to cater this broad segment.

**Table 1. Land Holding**

Categories	Frequency	Percentage	Cumulative Percent
Subsistence holding	182	65.0	65.0
Economic holding	92	32.9	97.9
Above Economic holding	6	2.1	100.0
Total	280	100.0	

In survey area, 50.4% respondents respond that they buy inputs (Fertilizers, pesticides, seeds, etc.) on credit and 95.7% respondents said they could save on average 14.08% if they purchase inputs on cash. 25% respondents are doing private jobs along with farming and 6% having Government jobs, and as a part-time, they work on their lands it may be the reason that

<sup>2</sup>State Bank of Pakistan Agricultural credit department for more detail visit [www.sbp.org.pk](http://www.sbp.org.pk)

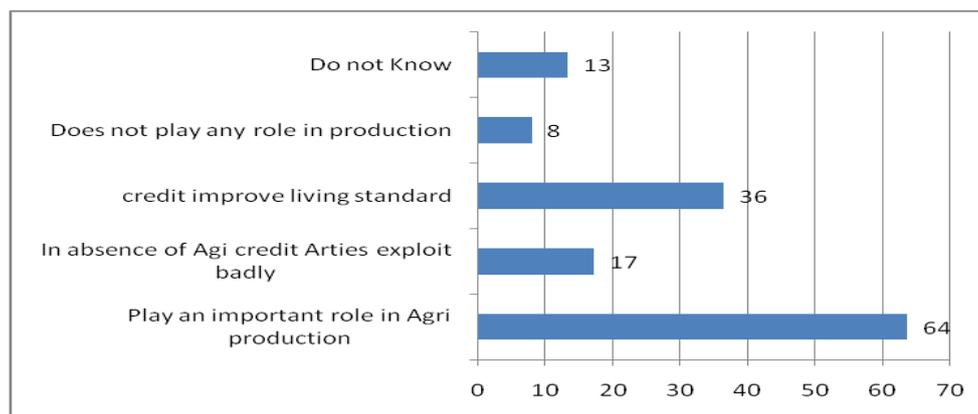
the percentage on credit purchase of inputs is low because 31% respondents are not solely dependent on agriculture.

### **Awareness**

However, lack of awareness of the farmers could be problematic for promoting *Bay Al-Salam*. The bankers must have to approach the farmers at grass root level to promote *Salam*. In survey area, we asked questions about the education of farmers so that it could be known what type of audience bank should have to approach. The results of the educational background of respondents are mentioned in table 2. We can see that most of the respondents in the market are literate and the bankers would have to approach educated respondents if they want to promote *Bay Al-Salam*. Results depict that in survey area only 3.6% respondents are illiterate, 17.1% having middle education, 40.7%, 23.9%, 8.6% and 6.1% having metric, intermediate, bachelor and master level education respectively. These figures tell us in Tehsil Gojra overall education level is good. If we see the cumulative percentage of Metric and above education it counts to 79.3% which is highly appreciated. This may be the reason that when we ask a question do you know about Agriculture credit and what is the importance of credit in agriculture production? 74% respondents answered in yes that they know about Agri credit and in the response of importance of Credit 64% respondent's answered that agriculture credit plays a vital role in Agri production, 36% respondents answered that Agri credit is a main element to enhance the rural people's standard of living, 17% respondent answered that in the absence of formal credit Aarhties/commission agents exploit the farmers. Only 8% respondents respond that formal credit does not contribute to Agri production and 13% respond they don't know about the importance of agriculture credit. See figure 3

**Table 2: Educational Background of The Farmers in Respective Area**

<b>Qualification</b>	<b>Frequency</b>	<b>Percentage</b>	<b>Cumulative Percent</b>
Illiterate	10	3.6	3.6
Middle	48	17.1	20.7
Metric	114	40.7	61.4
Intermediate	67	23.9	85.4
Bachelor	24	8.6	93.9
Master	17	6.1	100.0
Total	280	100.0	

**Figure 4. Importance of Agriculture Credit in Agri Production**

If we talk about the credit recipient 47.1% respondent takes credit for the formal credit system, and the remaining 52.9% either take a loan from the informal credit system or do not take loan. This shows that there is a vast market for IB's if they sincerely pay their attention to cater this huge segment. Khandker and Faruqee (2001) say to estimate the cost-effectiveness of ADBP "formal lenders are influenced toward big farmers who have collateral. Large landowners who represent 4% of the rural household get 42% of formal loans while landless and subsistence holding who represents 69% of the rural household receives only 23% of formal loans".

#### *Awareness About Salam finance*

*Bay Al-Salam* is an Islamic mode of finance recognized by the Holy Prophet (peace be upon him) and is currently acknowledged by the State bank of Pakistan as a source of Agriculture finance. However, many people do not know this financing option. In the present survey, we tried to measure the awareness of farmers and bankers about SF. We have also tried to estimate the willingness of customers to adapt *Salam* finance after briefing them about the modalities of *Bay Al-Salam* finance. The results are summarized below.

#### *Customers Awareness About Salam*

In this section, we tried to analyze the farmer's awareness about *Salam*, how much they are aware of *Salam*? In response to the question, what is your point of view about the interest-based financing? Table 3 shows 46.9% respondent replied that interest is prohibited in Islam and it shouldn't take, 42.1% said it is prohibited but in dire needs could be taken and 8.2% said we don't care of interest. In response to next question do you know about *Bay al-Salam* contract use the Islamic Banks for agriculture as an alternate of interest based financing? Table 4 tells us that 21.4% respondents replied they just hear the name, 61.8% replied they are listening to this name first time, 14.6% are those who have little bit knowledge about *Bay al-Salam* and only 2.1% said that they are fully aware of *Salam* contract figures shows that there is a strong need to communicate with farmers about these modes of finance which are especially for agriculture. After checking the awareness, we communicate with farmers about *Salam* contract and then try to know their willingness from different dimensions by asking different questions.

**Table 3. Personal Opinion About Agricultural Credit Provide by The Conventional Banks**

<b>Opinion about interest-based credit</b>	<b>Percentage</b>
Prohibited by Islam & shouldn't take	49.6
Prohibited but could be taken in dire need	42.1
I don't care at all	8.2
Total	100.0

**Table 4. Awareness About Salam Before Communicating About Salam**

<b>Awareness about Salam</b>	<b>Frequency</b>	<b>Percentage</b>	<b>Cumulative Percent</b>
Just hear the name	60	21.4	21.4
Listening to the name first time	173	61.8	83.2
I know a little bit about it	41	14.6	97.9
I am fully aware of it	6	2.1	100.0
Total	280	100.0	

*Bankers Awareness About Salam Finance*

Table 5 tells us that 25% respondents have good knowledge about Salam and its history, 31.3% have sufficient, and 20.8% are those who don't know the Salam finance, but they are working in Islamic banks which is the very astonishing thing most of our respondents were those who were dealing in Salam finance. We also interviewed the branch managers only a few of them were known about the Salam finance as a mode of agriculture finance.

**Table 5. Bankers Level of Knowledge About The Salam and Its History**

Level of Knowledge	Frequency	Percentage	Cumulative Percent
Excellent	4	8.3	8.3
Good	12	25.0	33.3
Sufficient	15	31.3	64.6
Poor	7	14.6	79.2
No Knowledge	10	20.8	100.0
Total	48	100.0	

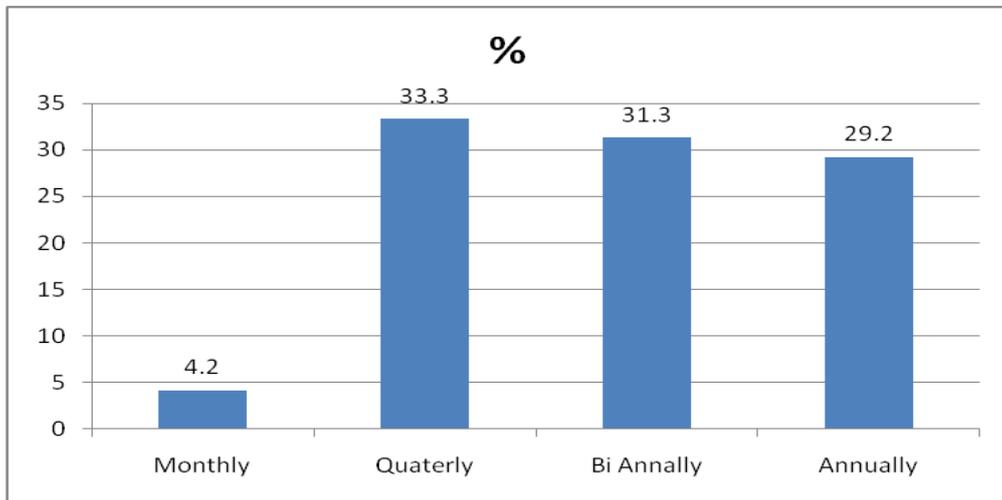
When asked a question how did you came to know about *Salam* as a mode of finance table 6 depicts that 31.3% respondents answered they learnt from their colleagues, 29.2% said that they learnt from different sources like internet, EBooks and books, 22.9% said they visited lots of conferences and seminars on Islamic banking and 16.7% were those who replied they learnt from banks because itself arranges workshops and training programs on Islamic banking. Therefore, this reflects the banker's knowledge is superficial which must be improved for the promotion of this mode.

**Table 6. Bankers Source of Knowledge About Salam Finance**

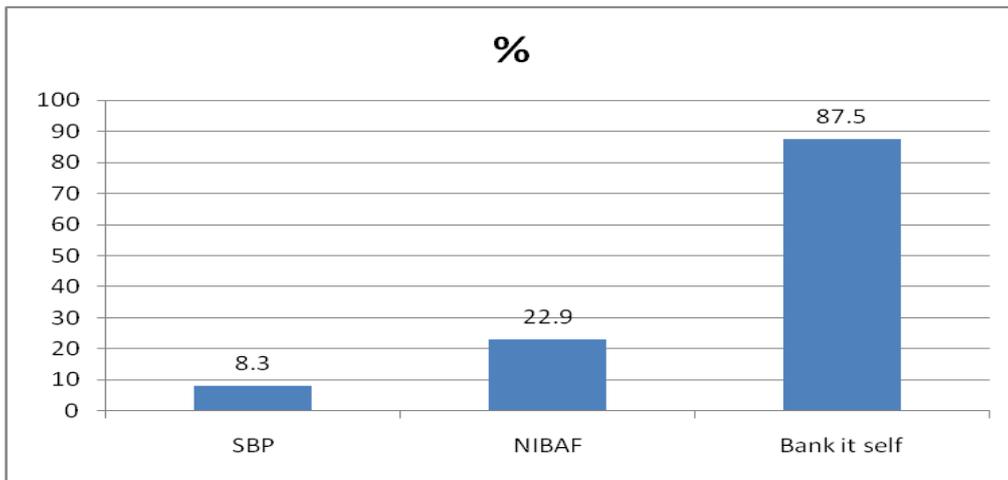
Sources of Knowledge	Frequency	Percentage	Cumulative Percent
I read from Books	14	29.2	29.2
Learnt about Salam from my colleagues	15	31.3	60.4
Visited a lot of conferences from where I learned	11	22.9	83.3
Others (From bank)	8	16.7	100.0
Total	48	100.0	

Next question we ask how frequently bank arranges training workshops? Figure 4 tells us that 33.3% respondent replied bank arranges training program on a quarterly basis, 31.3% said on a biannual basis, and 29.2% respond on an annual basis. In response of the question who arranges the training, 87.5% said that bank internally arrange the workshops and 22.9% respondent said NIBAF (National Institute of banking & finance) provide training but mostly it is being arranged for managers and executives.

**Figure 5. How Frequently Training Arranges**



**Figure 6. Which Institution Arranges The Training?**



If we compare the experience and average No of training sessions which they attended on Islamic banking there are huge discrepancies those who have 15-20years banking experience but didn't attend any training, on the other hand, those who have 10-14years experience attended on average 5.38 trainings which are double than average. Table 7 tells us that we cannot suppose that those who have more banking experience will have more knowledge about Islamic banking and vice versa. There is a strong need for systemizing the training system.

**Table 7. Comparative Analysis of Experience and No of Attended Training**

<b>Experience</b>	<b>Average No of Training</b>
Less than 5 years	1.69
Greater or equal to 5years but less than 10years	2.68
Greater or equal to 10years but less than 15years	5.38
Greater or equal to 15years but less than or equal to 20years	.00
Total	2.75

***Willingness to Adapt Salam Finance***

In this section first, we briefed the farmers about *Salam* finance, what is *Salam* why Islam allowed it as an alternate of interest based finance and then ask different questions to estimate the willingness.

To check the farmer's threshold of interest based financing to *Bay al-Salam*, we ask a question if conventional banks provide you interest-based financing at low rate what will you decide either you will take interest-based financing or will prefer *Bay al-Salam*? Table 8 shows that 83.6% respondents replied that they would never take interest-based financing because there are very clear verdicts on the prohibition of interest in *Quran* and *Hadith* and they will use *Salam* contract as an alternate, 8.2% respondents respond they will prefer interest-based loan because their point of view was that they don't know the procedure, process of *Salam* and they are taking financing from conventional banks from a long period, and they are aware of conventional banks and their loan procedure. 8.3% respondents were those who are on the bridge between the Islamic and conventional banks which may be turned toward *Salam* after practicing or hearing from those who practice it.

**Table 8. Customers Willingness to Adapt Bay Al-Salam**

<b>Customers willingness</b>	<b>Percentage</b>
I will prefer interest-based loan	8.2
Will never take interest-based loan because it is Haram	83.6
Will indifference between both	8.2
Total	100.0

Those respondents who do not participate in credit market due to the element of interest (*Riba*) when we brief them about Salam finance that in the *Salam* contract bank make a sale contract with the farmer and pay the full amount of the sold commodity in advance to the farmer. After briefing the respondent's table 9 tells us that 64.3% respondents showed a keen interest that they need such type of product, 30% replied they don't differentiate between interest-based financing and *Salam* financing, and the remaining 5.7% replied we don't think that there is a big difference between *Salam* and interest-based financing.

**Table 9. Farmers Perception After Communicating Them About Salam Contract**

Perception	Percentage
I do not find difference between Salam & interest based loan	30.0
I am waiting for Salam	64.3
Islamic banks are cheating on the base of Islam	5.7
Total	100.0

In survey area only 23.2% respondents have their account in an Islamic bank, and 64.61% said the reason for opening the account in Islamic bank is free of Interest (*Riba*), 20% replied they open their account in Islamic bank because the bank is near their home and 6.15% said Islamic banking staff is more cooperative than conventional bank staff. 4.6% respondents said that his relative is working in Islamic bank that's why he opened an account in that bank.

**Table 10. Main Reasons for Opening An Account in Islamic Bank**

Reasons for opening an account with IB	Percentage
Islamic banks are free of interest	64.61
Near to my home	20
Bank staff is cooperative	6.15
My friend/relative is working there	4.61
Having good reputation	4.61

<b>Reasons for opening an account with IB</b>	<b>Percentage</b>
Islamic banks are free of interest	64.61
Near to my home	20
Bank staff is cooperative	6.15
My friend/relative is working there	4.61
Having good reputation	4.61
Total	100.0

That 66.8 % who don't have an account in Islamic banks replied there are many reasons not to open an account 36.8% respondent replied there is no Islamic bank in their area, 26.4% replied people are not well aware of Islamic banking, and only a few Islamic banks have their branches in rural areas, 12.1% respondents replied there is no difference between conventional and Islamic banks. When we ask what is their point of view on the branch network of Islamic banks in rural areas 83% respondents replied there is no proper branch network of Islamic banks in rural areas. In table 11, 44.6% respondent said there is 5-10 km difference between the branch and village, 24.3% said the difference is more than 10km. The urban population of the Gojra city as per 1998 census is 117832.85, and there is only one branch of the Meezan bank to cater this population.

**Table 11. Approximate Difference Between The Branch and Village**

<b>Difference Between the Branch and village</b>	<b>Frequency</b>	<b>Percent</b>	<b>Cumulative Percent</b>
Up to 5 km	87	31.1	31.1
Between 5-10 km	125	44.6	75.7
More than 10 km	68	24.3	100.0
Total	280	100.0	

### **Hurdles and Risks Faced by The Customers and Bankers**

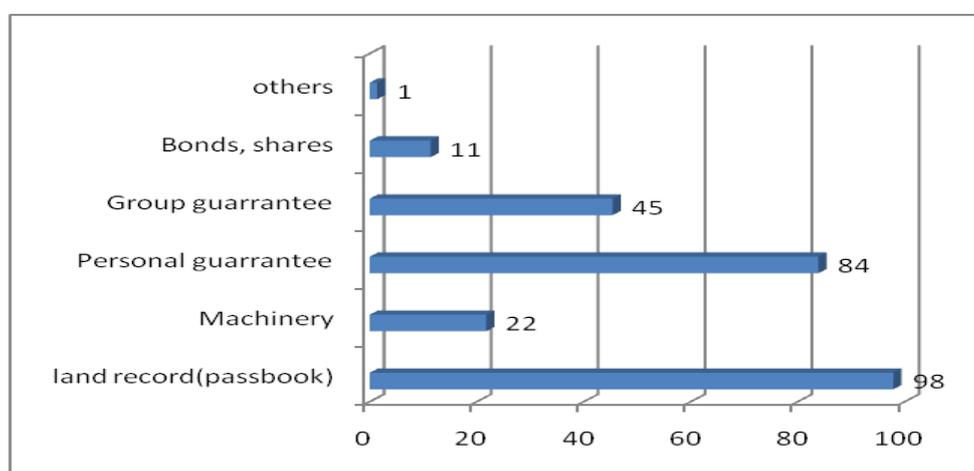
In this section, we discussed the Hurdles and the risks related to *Salam* finance from Customers and the farmer's perspective. Before taking any initiative to launch a new product these factors are paramount. The following section summarizes these factors.

#### *Customer's Opinion*

Survey results reveal that 47.1% respondents take credit from a formal credit system which is very high as compared with the report of State bank of Pakistan, formal sector caters only 10.4% of the potential customers (State bank of Pakistan, 2002). 28.6%<sup>3</sup> respondents said that they take credit from Aarhties/commission agents, 38.9% take from relatives, 35% take from friends, and 26.1% respondent said that they do not take credit from any informal credit system (Khandker & Faruqee, 2003). Less than half respondents participate in the formal credit system.

Reasons for not taking a loan from the formal credit system are many folds. 53.9% respondent said it is not easy to get a loan from formal system/Banks, 10% respondents said that they don't know because they never participate in the formal lending system. Those 53.9% respondents who said it is not easy to get a loan from the formal system because a formal lending system is very tedious and demand lots of securities. In figure 7 we can see that 98% respondent said bank demand land record/pass book as a security, 22% respond fixed asset like machinery, building accept as a security, 84% said bank accept personal guarantee as a security, 45% respondent said that bank demand group guarantee and 11% respond that bank accept bonds shares as a security if they have and 1% response in favor of other. Therefore, the securities that most of the customers provide in the shape of a land record (Passbook) along with a personal guarantee. The same securities could be demanded by IB's for *Salam* and IB's should not hesitate in the provision of *Salam* against these securities because their counterparts accept these securities.

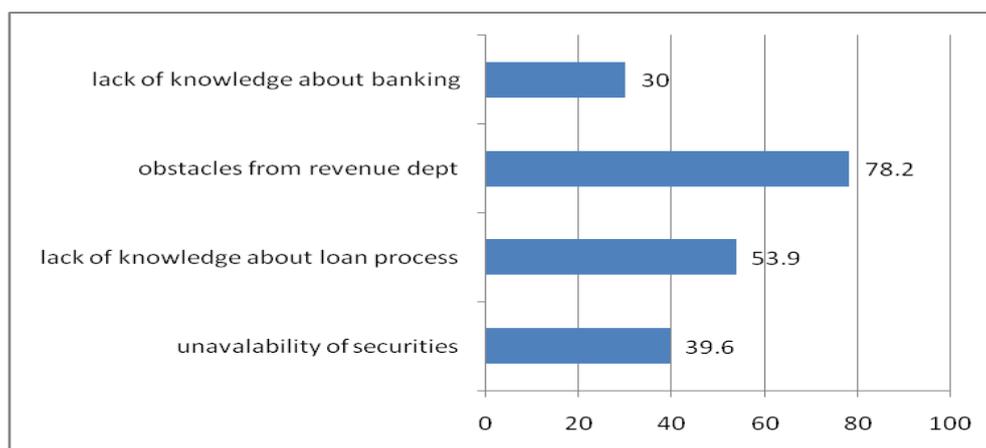
**Figure 7. Securities Required at The Time of Borrowing from Bank**



<sup>3</sup> (Shahidur R. Khandker, 2003) said in Pakistan informal loans like friends, relatives who do not usually charge interest are 57.2% and the remaining 42.8% informal loans are comprise on Arties/commission agents , shopkeepers, and commercial agents who provide inputs and charge the interest against the lend amount.

In response to the question what are the hurdles faced by the farmers is summarized in figure 8. Figure 8 depicts that 78.2% respondent said they have to face different types of obstacles from the land revenue department like they have to visit the land revenue department again and again to get the land record (*Fard*), and sometimes they have to pay bribe, 53.9% respond that they don't have any knowledge about the process of getting loan, 39.6% said they don't have securities for getting a loan and 30% said they don't have any knowledge about the banking system.

**Figure 8. Problems Faced at The Time Taking Loan from Banks**



When we ask what is your point of view about the lending process of the financial institutions is it of pure merit? Table 12 depicts that 21% respondent replied yes bank issue loan on merit base, 38% replied who have more political influence get soon, 20% said who offer bribe get soon. 40%<sup>4</sup> of respondent said they have to pay a bribe to take a loan and on average Rs: 500 they paid as a bribe (Basu, 2006). Those who did not pay bribe they said there are many reasons to not pay a bribe 68.37% said they didn't pay a bribe because it is prohibited in Islam, 23.72% said they use political reference and 3.72% said that bribe amount becomes more than the requested loan. See table 13

<sup>4</sup> World bank report (2006) on Indian rural finance reported that commercial banks and cooperative societies charge near about 12% interest rate and take the time to issue loan 33 weeks to 24 weeks and also report that 27% household confirmed they paid bribe to get loan.

**Table 12. Farmer's Response About The Financial Institutions Lending Process**

<b>Loan process</b>	<b>Percentage</b>	<b>Cumulative Percent</b>
Yes on merit	21.1	21.1
Who has more political influence get soon	38.2	59.3
Who offer bribe get soon	20.0	79.3
No merit	20.7	100.0
Total	100.0	

**Table 13. Reasons for Not Providing Bribe**

<b>Reasons for not providing bribe</b>	<b>Percentage</b>	<b>Cumulative Percent</b>
Bribe amount becomes more than a loan	3.72	3.72
Due to Haram	64.65	68.37
Used Reference	23.72	92.09
Merit-based	7.9	100.0
Total	100.0	

*Banker's Opinion*

Following questions were asked from the bankers to identify the hurdles in *Salam* finance. In response to the question is your bank providing *Salam* financing? 56.3% respondent replied in yes, and the remaining 43.8 said there are many reasons for not providing *Salam* finance. 23% Respondent said the main reason of not providing *Salam* is that their bank doesn't have relevant product for agriculture, and they sort it as most significant, and 22.9% replied that staff is not experienced in handling and managing the crops they put it at rank3. However, they showed interest in *Salam* contract and said that soon their bank would launch such type of products. 27.1% said it is difficult to assess the risk in *Salam* for the bank and they ranked it at rank4. In response of the question why do the banks reluctant to provide *Salam* finance to tenants, orchards and small farmers sort according to significant, 33.3% respondents respond that small farmers don't have any collateral and put it at rank1, again 41.7% said that tenants

don't have securities but they ranked it at rank2, 45.8% said there is lack of coordination between the bank and land revenue department. The dilemma is that Islamic banks use subterfuge to make the things Shari'ah compatible, actually *Salam* contract is for agriculture, and the bankers start to use it in currency *Salam*, and most of the Islamic banks are providing the currency *Salam* facility to facilitate the exporters.

**Table 14. Reasons of No Salam in Their Bank**

Ranks/ 1 for Most Important 2 for less Important and so on	Rank 1	Rank 2	Rank 3	Rank 4	Rank 5
Inexperienced staff in handling and managing crop	0%	12.50%	22.90%	8.30%	4.20%
Do not offer relevant financial product	22.90%	6.30%	4.20%	8.30%	6.30%
Difficult for the bank to sell the products	4.20%	25%	14.60%	4.20%	0%
Difficult to assess the risk	8.30%	0%	6.30%	27.10%	6.30%

**Table 15. Why Do The Banks Reluctant to Provide Salam to Tenants, Orchards**

Ranks/ 1 for most Important 2 for less Important and so on	Rank 1	Rank 2	Rank 3	Rank 4	Rank 5
Lack of securities	33.30%	41.70%	20.80%	4.20%	0%
Due to high default ratio	27.10%	14.60%	4.20%	37.50%	16.70%
High operational cost involve	12.50%	27.10%	25%	33.30%	2.10%
Lack of coordination between departments	25%	12.50%	45.80%	16.70%	0%
Wrong use of funds	2.10%	4.20%	4.20%	8.30%	6.30%

In response to what are the risks associated with *Salam* finance and how these risks can be mitigated and what remedial measure you will suggest? Table 16 tells us that 37.5% bankers put the Commodity Risk on top because bank pays the whole price of the commodity in advance and there is the probability that the seller may not deliver the commodity in time intentionally or due to unforeseen events. 41.7% respondents said banks reluctant to provide *Salam* finance for tenants, orchards and small farmers due to credit risk and they put it at rank2, and 37.5% bankers replied that they are reluctant due to liquidity risk because of bank deals in

documents and avoid dealing in goods. At rank5 60.5% bankers said that they avoid due to profit risk.

**Table 16. Risks Associated with Salam**

Ranks/ 1 for most Important 2 for less Important and so on	Rank1	Rank2	Rank3	Rank4	Rank5	Rank6
Profit risk	10.40%	0%	0%	12.50%	60.40%	16.70%
Commodity risk	37.50%	25%	20.80%	14.60%	2.10%	0%
Credit risk	6.30%	41.70%	22.90%	20.80%	8.30%	0%
Liquidity risk	22.90%	16.70%	37.50%	8.30%	12.50%	2.10%
Operational risk	12.50%	12.50%	16.70%	41.70%	12.50%	4.20%
Price risk	6.30%	0%	2.10%	0%	4.20%	6.30%

Table 17 shows that 33.3% and 41.7 respondents said that banks could mitigate the liquidity risk through parallel Salam, 33.3% respondent puts it at rank1 and 41.7% keep it at rank5. To mitigate the liquidity risk bank can make another Salam contract with a mill or exporter on the same date at a higher price, in first contract bank will buyer and in second contract bank will seller, the difference between the buying and selling price will be the profit of bank, but the most important thing is that both the contract will be independent. To mitigate the commodity and credit risks, 29.2% respondent said that bank could take collateral and 27.1% respondent said that most of the risks could be mitigated through proper screening and by avoiding adverse selection. 39.6% responded that by taking personal guarantees, delivery/commodity risk could be reduced because there will be pressure on the seller that if he does not deliver the goods in time, the buyer will confiscate his guaranteed property up to the price of goods.

**Table 17. Remedial Measure to Mitigate These Risks**

Ranks/ 1 for most Important 2 for less Important and so on	Rank1	Rank2	Rank3	Rank4	Rank5	Rank6	Rank7
By demanding collateral	16.70%	29.20%	25%	18.80%	2.10%	0%	4.20%
Taking personal Guarantees	2.10%	14.60%	20.80%	39.60%	14.60%	4.20%	0%
Through parallel Salam	33.30%	8.30%	14.60%	0%	41.70%	2.10%	0%
Through proper screening	20.80%	20.80%	27.10%	18.80%	10.40%	2.10%	0%
By avoiding adverse selection	18.80%	22.90%	12.50%	18.80%	27.10%	0%	0%
By improving literacy rate	8.30%	0%	0%	0%	0%	0%	0%
Documented Economy	0%	4.20%	0%	0%	0%	0%	0%

### ***Role of The Institution in The Promotion of Salam Finance***

#### *Customer's Point of View*

When we ask a question from farmers what is their point of view about Government does provide help in the process of taking credit and in other agriculture activities like provide subsidies on fertilizers, seeds, and pesticides. 65.7% respondents replied in No, only 28.6% said yes Government is providing help, and 5.7% replied that they don't know.

#### *Banker's Point of View*

In response to the question do you think that Government should play its role in the promotion of *Salam* 95.3% respondents said yes and 4.7% said no. There are some comments and suggestions provided by the bankers for the promotion of *Salam* finance for government and Islamic banks as well.

#### *How Government Can Play Their Role in Promotion of Salam Finance?*

- a) State Bank of Pakistan should play their role to push the banks that they must invest up to a fixed ratio of their advances in Agriculture financing.
- b) The government should identify the area and issue the regulations for the banks that they must finance up to some limit in *Salam*.
- c) The government should provide support to financial institutions to promote the *Salam* as providing for export financing.
- d) Can promote *Salam* by creating a joint venture with NRSP (National Rural Support Program) because NRSP is already working in rural areas and well aware of the market.
- e) Launch new favorable policies for agriculture with the consent of IFI's and keep in view all the reservations of IFI's.
- f) By establishing those institutions that must have specialties in *Salam* contract.
- g) Minimize the documentation and offer *Salam* at discounted rates to penetrate the market.

- h) To create awareness among the general public about Islamic financial system government should revise the educational curriculum and should introduce about Islamic modes of finance at different stages, i.e., up to metric- primary level, Up to Intermediate-Medium level, And in graduation- advance level.
- i) By forming cooperative societies of small farmers.

*How Islamic Banks Can Play Their Role in The Promotion of Salam Finance?*

- a) By appointing the trained staff in rural areas where banks are already working.
- b) Appoint knowledge full and well-trained staff in those areas where *Salam* market is rich that they may convince and facilitate the farmers properly and can remove the confusions about Islamic banking specifically about *Salam* finance.
- c) Banks can play a vital role to Finance the entrepreneurs and encourage them because in this way banks' risks will be mitigated and farmers will contribute to overall agriculture.
- d) By offering a flexible profit rate to their customers.
- e) Should develop their research and development departments and make innovations through financial engineering.
- f) Reduce the documentation and unnecessary formalities and by flexible terms and conditions.
- g) Provide mobile banking services through field officers at the door steps of the farmers.
- h) Trust building among farmers and bank employees.
- i) Open new branches in rural areas and follow all the Islamic modes of finance in true letter and spirit.

*How Islamic Banks Can Play A Role in The Promotion of Islamic Banking?*

- a) By conducting Seminars, workshops, and training on Islamic banking especially for those staff who deals with *Salam* financing.
- b) By arranging road shows and stalls with the collaboration of different companies.
- c) By launch the awareness program with the collaboration of print media and electronic media.
- d) By starting a video and audio lecture series on Islamic banking to create the awareness in rural areas.
- e) By creating links with the land revenue department to make the system more transparent.
- f) Arrange question-answer sessions to eliminate the confusions about Islamic banking.
- g) By advertising the salient features of their products in a different type of print media.
- h) Launch new Shari'ah compatible products.

*How Proxy Loaning Can Be Avoided?*

- a) Agriculture economy should be documented, and all the agriculture purchasing, i.e., pesticides, fertilizers, seeds must be through a bank.
- b) Moral values should be built among the employees by a bank through proper training.
- c) By incorporating specialized agriculture financing institutions.
- d) Should be a board that sanctions the agriculture loan on merit base after proper monitoring and screening the requests.
- e) By using Islamic modes of finance like *Murabaha*, *Ijara*, and *Salam* because Islamic modes are asset-based.
- f) Close coordination with clients and compliance monitoring.
- g) Through Peer pressure

## Conclusion and Recommendations

### Conclusion

Credit is an essential part of the agricultural economy, but the conventional agriculture financing is interest-based. Interest is prohibited in Islam, and the alternate for agricultural finance is *Bay Al-Salam* contract.

Currently, the share of *Bay Al-Salam* financing is limited to 5.2% of the total Islamic banking the main reason of low share; bankers are interested in the corporate sector instead of the agriculture sector. Most of the branches do not offer Salam financing. To increase the share of *Salam* finance, there is a need for a 90-degree shift in financing approach- from interest-based loans to toward forward sale contracts of crops.

This study overall concludes the banker's and farmer's awareness, willingness, risks, hurdles and the role of institutions in the *Salam* promotion. The majority of the farmers are not aware of the Salam contract because the Islamic bank's branch network is limited to urban areas and there is no proper promotion campaign launched by the Islamic banks for awareness about *Salam* among the farmers. The staff working in most of the branches hired from conventional banks that's why they are not enriched in Islamic modes of finance. Bankers are reluctant to finance the tenants, orchards due to more operational risk for the bank.

A lot of farmers do not get a loan from formal institutions because of the element of Interest (*Riba*). Those farmers who get a loan, think that they are being exploited by the conventional banks and middle man (*Aarthies*).

All this tells us that there is a big room for *Salam*. Because most of the farmers are educated, and they could be easily convinced. The major issue is most of the bankers do not have proper knowledge about *Salam*. And those who know about *Salam* are unable to provide *Salam* because banks do not offer it. Those banks which have *Salam* based product they offer to the corporate sector only. Bankers opinion that small farmers do not have personal securities which is not a solid reason because half of the sampled farmers take a loan from the formal system if they can provide securities to conventional interest-based institution why they can't provide securities to Islamic financial institutions? In 1988 State Bank of Pakistan banned the agriculture credit against two personal guarantees due to proxy loaning, paper loaning, and family loaning; survey results show bankers opinioned that only 2 percent farmers are those who misuse funds.

Farmers showed a keen interest in *Salam* finance because they want to get rid of the evils of interest. There is a vast market for the Islamic Banks if they sincerely pay their attention towards forward sale contracts.

### Recommendations

Agriculture financing through *Bay Al-Salam* contracts can be supportive in reducing poverty in rural areas through the timely availability of advance credit and priority purchases of outputs from the small farmers, orchards, and tenants. *Bay Al-Salam* contract can be constructive in minimizing the price volatilities by locking the future prices through advance agreements.

*Bay Al-Salam* contracts, along with traditional risks, may also expose the banks to face the risks such as non-performance risks, default risk, and crop damage risk, etc. The banks should introduce agriculture-related insurance schemes to diminish these risks. Further, *Bay Al-Salam* may be introduced initially on limited scales to minimize any enforcement problems and to avoid informational asymmetries at the time of transition.

State Bank of Pakistan should take help to train the bank staff in Islamic economics and banking from those professional and academic institutions that have their expertise in Islamic economics and Islamic banking, e.g., IIIE, NIBAF, Dar-ul-Uloom, etc.

Some major institutional changes for smooth implementation of *Bay Al-Salam* contracts should be done, e.g., computerization of existing land record should be completed on a priority basis to avoid financial losses and malpractices.

Banks can also motivate the farmers to adopt best practices in farming with the available money. They can launch special training sessions and can arrange seminars, awareness programs for the farmers, to understand the advantages of *Bay Al-Salam* contracts. Banks should develop such type of procedures which insure the farmer credibility and moral worthiness.

State Bank of Pakistan may fix a quota for the banks that they must finance up to a fixed ratio of their advances in *Salam* financing.

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