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THE ROLE OF ISLAMIC BANKING IN AGRICULTURE FINANCING (CASE STUDY OF INDONESIAN AGRICULTURE SECTOR)

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Abstract

Purpose: This paper aims to analyze the role of Islamic banking in improving the agricultural sector as well as providing alternative solutions such as financing scheme for agricultural financing.

Methodology: The research method is qualitative. A review of the extant literature was carried out for collecting primary and secondary data. In-depth interviews with key informants such the farmer and Islamic bank financing manager were also conducted. Data analysis was performed by adopting data reduction, data display with SWOT matrix, verification, and conclusion.

Main findings: This paper finds that Islamic banking allocates financing for agricultural sector which is less than 10 percent of total financing. The finding is in line with the problem faced by the farmer. Based on the interview, it is known that the main problem of agriculture industry is limited access to the source of capital. The second finding pertains to the lack of Islamic banking's role in agricultural financing caused by high risk perception and minimum competence of human resources to maintain the agricultural financing.

Applications: This paper suggests the implementation of Ba'I As Salam scheme as an alternative for agricultural financing. Salam Financing Scheme is more suitable for agricultural financing than the murabaha financing that are commonly used today. Because the salam financing scheme intends to finance the sale and purchase of new commodities that are to be processed or produced and the delivery of their goods in the future, as well as allow for irregular payment schemes made in the harvest. Some of these advantages can be agricultural financing solution that is more in line with the characteristics of agricultural sector cash flow.

Novelty/Originality of this study: Previous Studies related to the agricultural sector only deals with the impact of agricultural finance without offering low cost financing models as the solution to the main problem in the agricultural sector. This study provides solutions to these problems.

Keywords: *Islamic Banking, Agriculture, Finance, Indonesia*

INTRODUCTION

The agricultural sector will always be an interesting issue for countries with large populations such as Indonesia. Moreover, Indonesia has a very wide agricultural land. Thus, the important role played by the agricultural sector in providing food for the entire population is undeniable. It is a known fact that the need for food will continue to remain throughout human life. In the case of Indonesia, the agricultural sector can be regarded as one of the main pillars of the economy for two main reasons. Firstly, a majority of Indonesians work in this sector and secondly, it is the second largest contributor of the country's Gross Domestic Product (GDP). However, most of the poor people in the country work in the agricultural sector. This means that even though the agricultural sector contributes largely to the national economy, many farmers are still living below the poverty line.

Banking as a financial intermediary institution has an important role in providing access to capital for all sectors of the economy, especially the agricultural sector. The focus of banking in Indonesia is still dominated by corporate financing, and consumer financing. The banking financing policy is not yet in favor of the agricultural sector which is one of the main pillars of Indonesian economy.

The development of Islamic banking in Indonesia is expected to provide financing solutions for small and medium enterprises especially agricultural sector. This optimism is because Islamic banking is theoretically considered to be able to link the growth of the financial sector with the real sector so as to minimize the economic disparity. This paper seeks to explore the role of Islamic banking in increasing the productivity of the agricultural sector and offer a financing model that can be a solution to the problems of the agricultural sector.

Central Bureau of Statistics data shows that in 2016, agricultural sector was the occupation that absorbed most of the labor, which amounted to 32 percent of the total workforce or about 37,770,165 people. This was followed by the trade and hotel sector, community service, and the manufacturing sector. This proves that though the agricultural sector has not been able to provide welfare, most of the labor force has been absorbed in this sector. However, the proportion of energy absorption in the agricultural sector has decreased since 2009, when the sector absorbed about 39.7 percent of the workforce (Statistic of Indonesia, 2010). The decline is of course not separated from the agricultural transformation process that can be associated with the migration of agricultural workforce into a more productive sector, industrial sector for example (Wickramasinghe, 2012).

Regarding the contribution towards Gross Domestic Product (GDP), the agriculture, forestry and fishery sector contributed no less. In 2016, this sector became the second largest contributor of GDP after the manufacturing sector, which is about 13.45 percent. In general, this contribution has increased from the year 2012, during which the sector of agriculture, forestry and fisheries accounted for 13.37 percent (Indonesian National Growth, 2012-2017).

LITERATURE REVIEW

Islamic Banking as an Alternative Solution for Economic Development

The idea of Islamic banking emerged as the economic gap widened. The massive exploitation of the economy by the owners of capital further worsened the conditions of the poor, so the gap between the two has become increasingly difficult to be resolved. The emergence of Islamic banking gives great hope to the improvement of the society's economic condition. With the principles of sharia, this institution is considered capable to encourage the welfare of society and reduce the gap. The concept of justice is the main characteristic of Islamic banking, which prohibits usury and other exploitative elements such as gharar, maysir, fraud, bribery, reduction of scales, taking wealth with crime and transactions on illicit goods (Saleem, 2013). Therefore, the various commercial contracts offered by Islamic banking is believed to be able to improve the condition of society, especially in the economic field, and able to make the people realize its benefits, as the goal of maqasid shariah.

According to Asutay (2014), the foundation of Islamic banking (finance) is the moral of Islamic economics, so it should be not just a ban on usury (interest), but also related to the issue of socio-economic development. Leaman (2015) also argues that Islamic banking is expected to be more than just a commercial institution, based on sharia principles that forbids to concentrate only on their own institutions, but also to pay attention to social responsibility. The implication is that Islamic banking must maintain the balance of benefits gained between institutions and society. In allocating financing, for example, the banking sector is expected to focus not only on sectors deemed to be able to provide more benefits for banks and capital owners, but also to consider other sectors that have the potential to promote community welfare. So much hope of many parties on Islamic banking can be realized, inequality and poverty that has been happening can be reduced significantly.

Islamic banking as part of the Islamic economic concept is a representation of economic morale for the financial sector. So the course of profit making must be based on the principle of justice and equity. It is also affirmed by Askari, Iqbal and Mirakhor (2015) that the foundation of the Islamic economic system is social and economic justice. In addition, as mentioned above, Islamic banking that is based on Islamic law has also the responsibility to realize the benefits of the people. Consequently, Islamic banks inevitably also have to start paying attention to social welfare, not only through the Corporate Social Responsibility program, but also through financing activities in favor of smallholders.

Islamic banking operate in ways that differ from their conventional counterparts. Nonetheless, they provide the fund owners as well as fund users with profitable opportunities. On the liability side, they provide owners of funds with opportunities to place their financial resources profitably, as they become implicit partners of those institutions that share in their net profit, while carrying a proportional share in their risk. On the asset side, they provide finance to enterprises through either sharing directly in the net results of their activities or financing their purchases of assets, goods, and services (al-Jarhi, 2001).

Islamic Banking and Farmer Welfare

Poverty in Indonesia is dominated by rural poverty, where the livelihood of majority of rural people is agriculture. Based on the data from BPS (Statistics Indonesia, 2017) in 2016, the number of rural poor is around 17.28 million people or about 62.2 percent of the total poor population. On the other hand, the urban poverty amounted to 10.49 million people. In general, the poverty rate in both the regions decreased, although in 2015 there was an increase of 2.8 percent in urban areas and 2.9 percent in rural areas. Another indicator that can be used to see the farmer's welfare level is income per capita, where in 2014, the income level per capita of farmers in the broad and narrow sense is Rp. 9,032 / capita / day and Rp. 7,966/ capita/ day (Statistic of Indonesian Agriculture 2015-2019). This condition is still below the poverty line standard set by the World Bank, i.e. US$ 2 / capita / day. The result of the calculation of the Multidimensional Poverty Index (MPI) in Indonesia also shows the poverty rate in rural areas was higher than urban areas. The research of Budiantoro, Martha and Sagala (2015), using MPI calculations indicate that the national poverty rate is 79,583,588 people, or about 29.7 percent of the total population, with 68.8 percent among the villagers and 31.1 percent among the urban population.

In macro terms, the agricultural sector is making a considerable contribution. Aside from being the second largest contributor to GDP and number one employer, some studies show that the agricultural sector has more impact in reducing poverty than other sectors. Ravallion and Datt (1996) found that in India, the growth of the agricultural sector is more effective in reducing poverty (Suryahadi, Hadiwidjaja and Sumarto, 2012). Montalvo and Ravallion (2009) found that the primary sector (agriculture) makes a significant contribution towards reducing poverty in China than the secondary sectors (Cervantes-Godoy & Dewbre, 2010). According to Christiaensen, Demery and Kuhl (2010), the agricultural sector has a significant and more effective impact on reducing poverty because the participation rate of the poor in this sector is large and the size of the sector in the overall economy is considerable.

In Indonesia, the growth of the agricultural sector is the biggest factor in reducing poverty, both rural and urban poverty (Sumarto & Suryahadi, 2004). The growth of rural agriculture strongly reduces poverty in the rural agricultural sector, and its contribution towards poverty reduction is large (Suryahadi, Suryadarma & Sumarto, 2006). The magnitude of the impact of the agricultural sector on poverty in Indonesia is mainly due to the large contribution or involvement made by the people in this sector, where the majority of Indonesians work in the agricultural sector.

The agricultural sector plays an important role in handling the food needs of a country. If domestic agricultural products are able to supply national food needs it will provide a multiplier effect on the economy as a whole, or it can be said that it has a double impact than other sectors. Manpower will be optimally absorbed, economic growth will be improved, poverty can be suppressed, food prices can be stabilized and ultimately the welfare of society including both farmers as the main actors and the wider community can be realized. Moreover, food is a basic human need, it is necessary for a country to be able to meet the food needs of the people in its country through domestic products rather than placing the fate of its citizens to the imported products. Therefore, it is important for the government and stakeholders to do their best to improve the productivity of the agricultural sector. Banking, one of the institutions that provide financial services (financing), plays an important role in this case. With the fulfillment of capital requirement, the productivity can be improved. But in fact, the agricultural sector is still a sector that is avoided by banks, it can be observed from the fact that the allocation of financing for agriculture is still small compared to other sectors.

METHODOLOGY

This research is a qualitative research. Accordingly, a study of relevant literature with primary and secondary data source was carried out and then analyzed descriptively. Subject / key informant of the research is the Financing Manager of Islamic bank and the supporting informant is farmer who has received agriculture financing. The sampling technique adopted is accidental sampling.

The methods of data collection employed is in-depth interview with key informant. The validity of the data was analyzed by the researchers using internal validity (credibility), by extending the involvement of researchers, making careful observation and triangulation theory. This was followed by verifying the external validity (transferability), reliability (dependability) and objectivity (confirmability) of the collected data. The data analysis techniques used in the study include data reduction, Data display using SWOT matrix, verification, and conclusion.

DISCUSSION / ANALYSIS

Highlights of Capital Access as the Major Problem in Indonesian Agricultural Sector

Some of the problems faced by the agriculture sector are land, infrastructure, technology and capital access. The rise of infrastructure development such as roads, offices, housing, industrial estates and others has led to large-scale conversion of agricultural land. Nationally, paddy fields during 2012 to 2015 decreased by 0.55 percent, while the garden area decreased by about 0.85 percent (Agricultural Statistics, 2016).

Capital becomes an obstacle to the agricultural sector. The need for capital in the agricultural sector has not been fully met by the government and banking policy programs. This sector is regarded as one of the sectors that have high risk, so the banks apply an extra careful credit policy. The elusive requirements of farmers and long-term disbursements are some of the consequences of banking prudence in the sector. Meanwhile, the majority of farmers in rural areas are those who have business on a small scale. The results of observation and interviews indicate the fact that the constraints experienced by farmers are the factors of capital and natural risk. Farmers face limited capital and are exposed to substantial and uncertain risks such as climate change, plant pests, limitations with technology, high prices of pesticides and pest medicines that can result in unsuitable harvest yields and even harvest failures. On the other hand, farmers are also faced with the cost of capital to cultivate in new agricultural land (based on interview with the farmer, Sueb).

Such conditions often force farmers to turn to informal financing sources whose processes tend to be easier, albeit at a high rate of return. The inclusion of farmers in the circle of high-cost capital providers makes it harder and worse for the smallholders to develop agricultural enterprises. When the farmers access capital through middlemen, who will supply the inputs required by farmers, the crops should be sold to them at a low price. In such cases, the farmers will not be able to enjoy maximum benefits when the prices of agricultural products increase.

Based on the data provided by the Ministry of Agriculture in 2015, the agricultural sector only absorbs 9 percent of the total loans provided by banks; thus, there is a considerable difference between the agricultural sector and other industrial and trade sectors.

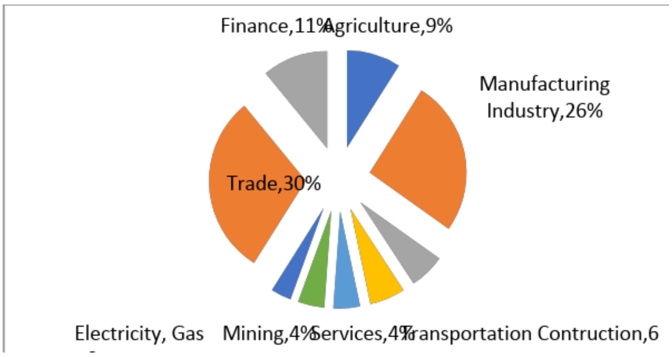

Figure 1. Credit allocation by sector, 2016

(Source: Macro Statistic of Agriculture, 2016)

Various government policies have been undertaken to boost the performance of the agricultural sector. The latest is the People's Business Credit (KUR) policy and interest subsidy. KUR is aimed at Small and Medium Enterprises (MSMEs) where agricultural businesses become one of its key sectors. Executor of this program is the government-appointed banking sector, while the government also provided interest subsidies. In order to provide security guarantees to the banks, the government appointed KUR as the guarantor. In 2007, when for the first time this policy was issued, banks were able to distribute KUR funds of up to Rp. 17.19 trillion, which increased to Rp. 171.67 trillion in October 2014, with Non Performance Loan (NPL) of 3.2 percent (Farida et al., 2016).

Lack of Islamic Banking Role in Agricultural Financing

The development of Islamic banking is currently induced to lead to the conventional financial system (Zaman & Asutay, 2009) as well as in the social aspects resulting from the transformation to commercial banking (Asutay, 2012). One of the arguments over the criticisms above, according to Asutay (2012), is that the majority of financing Islamic banking is a murabahah scheme, with a mark-up scheme that is debt-based like a conventional bank, while other contracts such as mudharabah, musharaka and qard al-hassan which are the main characteristics (Islamic banks are often referred to as banks with profit-sharing principles to assert differences with conventional banks) of Islamic banking portions are still very small. In the case of Indonesia, in March 2017, the proportion of financing with murabahah scheme still dominates 57 percent of total financing.

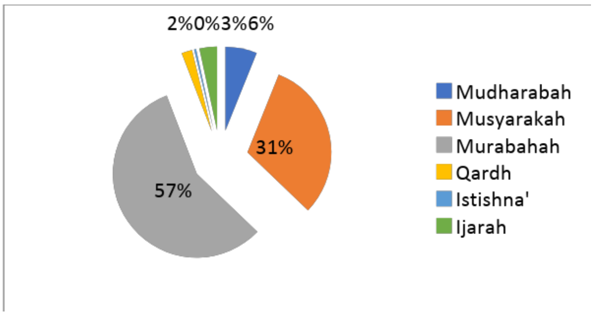

Figure 2. Competition in Financing

(Source: Statistic of Islamic Banking, March 2017)

The agricultural sector, which is a representation of the poor and small people, has not yet fully benefited from the presence of Islamic banking; whereas, this sector has a large impact on other macro sectors. The financing and credit channeled into this sector is still small, more than 10 percent. In 2016, the distribution of financing in the agricultural sector is only about 9 percent of the total financing. Islamic Rural Bank (BPRS), which is categorized under banks and considered to be able to meet the financing needs of the poor people, also provided only 6% of its total financing for the agricultural sector in 2016 (SPI, January 2017).

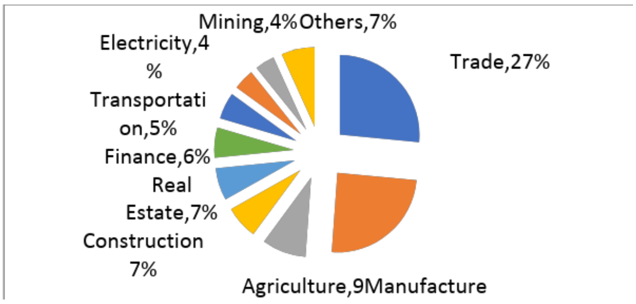

Figure 7. Financing Allocation by the Economic Sector 2016

(Source: Statistic of Islamic Banking, 2017)

A common argument related to the low allocation of financing to the agricultural sector is that the agricultural sector is associated with very high risks. However, the Islamic Banking Statistics data during the period from January 2016 to March 2017 on financial performance, shows that the Non Performance Financing (NPF) is better than two main sectors of banking, i.e. commerce and industry. The trade sector during the early to late 2016 was found to be more than 8 percent, with the highest rate of 9.78 percent in May. Then, in the next period it decreased and reached 7.19 percent in March 2017. Further, for the industrial sector during this period, the Non Performance Financing actually moved upwards, starting from 5.56 percent in January 2016 to 6.58 percent in March 2017 with the highest value of 6.83 percent. Interestingly, for the agricultural sector showed better financial performance, while the Non Performance Financing tended to decrease. In January 2016, the NPF of this sector was at 5.7 percent and then decreased to 3.67 percent in March 2017. Non Performance Agricultural Financing was highest at 5.96 percent in May 2016. From the data, it can be seen that the worst performance of agricultural sector NPF during this period was still better than the worst performance of trade and industry sectors.

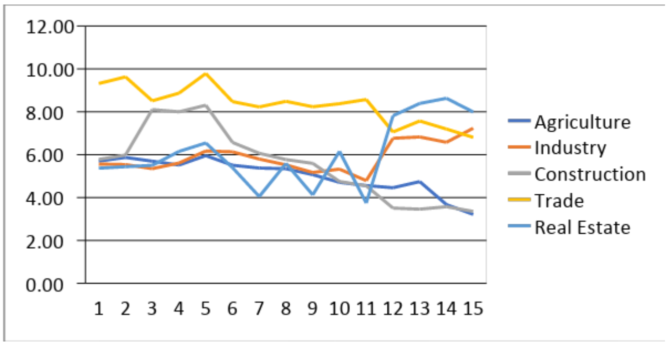

Figure 8. Non Performing Financing - *Source: Statistic of Islamic Banking, 2017*

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The performance of the agricultural sector was found to be better than the trade and industry sectors. This shows that the risks involved in agriculture that has been a major concern of the banking system can actually be managed well. To that end, Islamic banking is expected to begin to do business in this sector, given the banks have a responsibility to encourage the benefit of the people. In addition, this sector also has a large multiplier effect for the national economy and community welfare.

Challenges in Implementing Agricultural Financing in Indonesian Islamic Banking

Banking should be present as one of the institutions that provide financial services and solutions related to additional capital of farmers. With the fulfillment of capital requirement, the productivity can be improved. But in fact, the agricultural sector is still a sector that is avoided by banks and this is evident from its minimum allocation for agricultural financing compared to other sectors. Banking provides only minimum finances for the agricultural sector for several reasons. One of them is the existence of a depth in the field of competence of human resources who rarely control the field of agriculture. In order to minimize the potential risk of non-performing financing, the banks must enhance the competency of its employees (interview: Financing Manager of NN Islamic Bank, March 25, 2018). In addition, different harvest periods between commodities cause differences in the formulation of payment models in the contract. Islamic banking implements mudhorobah, musyarakah and murabaha contracts in agricultural financing. The most popular financing scheme used is the murabaha scheme. In order to respond to the different harvest periods of agricultural commodities, banks use irregular payment schemes or installment payments with special timing during harvest. We criticize the murabaha scheme because there is surrender of yield during harvest (commodity acquisition time is not current). According to the researcher, more precisely, by using Ba'I As Salam contract with basic assumption that trade contract can be done on the present and the delivery of commodity at the time of agreement which will come (the harvest).

SWOT Analysis

SWOT analysis is carried to provide an overview of the company's situation including internal resources (strengths and weaknesses) with external situations (opportunities and threats). From the interview transcripts obtained from the informants and secondary data analysis, the strengths, weakness, opportunities and threats of Islamic banking in the distribution of agricultural financing can be understood. The results are as follows:

Strengths

1. Various commercial contracts offered by Islamic banking is believed to be able to improve the condition of society, especially in the economic field.
2. Islamic banking provides several contracts for agricultural financing such as mudharabah, musyarakah, murabahah, and salam.
3. The 2017 financing performance, seen from Non Performance Financing (NPF), has been found to be better than two main sectors of banking (commerce and industry).
4. The performance of the agricultural sector is better than the trade and industry sectors according to Non Performance Financing (NPF) indicator, which in turn shows that the risk can actually be managed well.

Weakness

1. The need for capital in the agricultural sector has not been fully met by the government and banking policy programs, as this sector only absorbs 9 percent of the total loans provided by banks.
2. The proportion of Islamic banking financing is dominated by the murabahah scheme (57 percent of total financing).
3. Murabaha scheme is not applicable for agricultural financing because murabaha asset must exist when the contract is made not later on as in the harvest period.
4. Lack of competence among the Islamic banking human resources in agriculture.
5. Different harvest periods between commodities cause differences in the formulation of payment models in the contract.

Opportunities

1. Agricultural sector is the second largest contributor of the Gross Domestic Product.

2. Some studies show that agricultural sector has more impact on reducing poverty than other sectors.

Threats

1. This sector is regarded as one of the sectors that have high risk, so the banks apply extra careful credit policy.
2. The elusive requirements of farmers and long-term disbursements are some of the consequences of banking prudence in the sector.
3. Farmers are faced with limited capital but are exposed to substantial and uncertain risks such as climate change, plant pests, technology, high price of pesticides and pest medicines that can result in unsuitable harvest yields and even harvest failures.
4. Farmers suffer from high capital costs for cultivating in new agricultural land.
5. Many farmers are still living below the poverty line.
6. Poverty in Indonesia is dominated by rural poverty, where the majority of rural livelihoods are agriculture.

a. Strategy Formulation

1. To minimize the potential risk of non-performing financing, Islamic banking human resources must master the whole aspect of competence in agriculture.
2. Based on the better performance of Non Performing Financing (NPF) of agriculture sector, Islamic banking is suggested to diversify the financing portfolio by allocating more for agriculture.
3. To respond to the different harvest periods of agricultural commodities, banks use irregular payment schemes or installment payments with special timing during harvest.
4. Implementation of Ba'I As Salam is the better alternative agricultural financing scheme with basic assumption that trade contract done on present by delivery of commodity at time of agreement which will come (the harvest).

Ba'I As Salam Contract as an Alternative Financing Solution in Indonesian Agricultural Sector

One of the basic problems in the agricultural sector is the availability of credit / financing. The increasing demand for pesticides, fertilizers, superior seeds and mechanization leads to an increase in the demand for financing / credit. According to Gratitude and Kurnia, segmentation of agribusiness entrepreneurs in terms of banking including: feasible and bankable agribusiness groups, feasible but not bankable, not feasible but bankable, and not feasible and not bankable. This segmentation impacts financing in the limited sector of pertaniaan. This is in perparah with the enactment of high interest rates almost equivalent to commercial interest rates.

One of sharia financing that can be used for agriculture is Ba'I As Salam. Ba'i As Salam contract is a buying and selling agreement between an Islamic bank and a customer for a good, where the price is paid by the bank immediately, but the delivery of the goods will be done on a daily basis within the agreed timeframe. Terms of Ba'i As Salam contract is that the type, size, quality and quantity of goods sold must be clear and profitable. The profit earned by the Islamic Bank comes from the difference between the selling price of the bank and the other party. The mechanism used is parallel salam, in which Islamic banks enter into two separate contracts and work as mediators between the first party and the seller (producer) and between the second party and the buyer (commodity). In financing this contract, the agreed price is lower than the market price with the aim that the interests of the buyer is not neglected while the farmer fulfills his needs, both capital for replanting and the need for his family every day. However, pricing using future market prices is not permitted. For the realization of the fulfillment of the basic human needs in the view of Al Maqashidu Shariah, the contract Ba'I As Salam can be used as a financing of sharia in the agricultural sector.

Ba'i As Salam is a combination of financing, sales and production. Therefore, to encourage the fulfillment of the noble ideals in the welfare of farmers and increase the production of agricultural products, the Islamic banking as an intermediary institution can channel the greeting funding with a margin of 10-15%. The recommended margin for the welfare of farmers is 12.5% with a maximum period of 6 months. If the period of agriculture is more than 6 months, then it is advisable to renegotiate with an increase of 0.5% margin value. However, this still needs to be studied further.

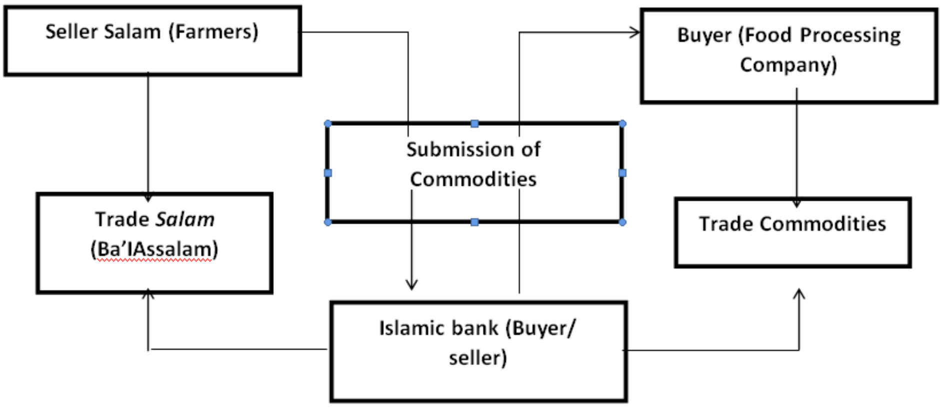

Figure 5. Scheme of Bai As Salam Financing

In the execution of Ba'I As Salam financing, the risks involved due to the farmer's failure to deliver the agricultural products cannot be neglected. In order to minimize the risk, Islamic Banking can apply one of the following solutions: Firstly, if the farmer is unable to deliver the quantity of agricultural produce (less quantity) according to the farmer's assessment, the farmer is required to hand over the purchase money in accordance with the lack of quantity of goods delivered. Secondly, in case of crop failure due to weather conditions, or disaster and not due to farmer's negligence, the Islamic bank may ask the farmer to reschedule or postpone the delivery of agricultural produce in the next harvest period. Thirdly, farmers as sellers can buy other farmers' products to cover the quantity of goods they lack to be delivered to the buyers (Islamic bank) with the same quality.

CONCLUSION

Islamic banking, as part of the Islamic economic system, has the responsibility towards the welfare of society. Therefore, the presence of Islamic banking should be felt at all levels of the society, especially the poor because Islam is basically in favor of the poor. The agricultural sector which is the backbone of the national economy but still a hotbed of poverty has not really been touched by Islamic banking. This is evident from the size of the proportion of finances allotted to the agricultural sector which until now is no more than 10 percent of the total financing issued, in spite of this sector being the second largest contributor of GDP and the largest absorber of labor in Indonesia. However, poverty is still a classic problem in the agricultural sector. Islamic banking with all its potential is expected to engage more in this sector, because the contracts used are very applicable to agriculture. Agricultural financing performance seen from Non Performance Financing shows that if this sector is managed very well, the risks that are feared can be avoided. The data shows that the performance of financing the agricultural sector is better than the two sectors that always become the mainstay of Islamic financing. To that end, the government as the holder of the policy authority should encourage the banking sector to pay more attention to the agricultural sector. In addition, the process of financing should be done in a partnership relationship between banks and the farmers. In this case, the banks can assist the farmers who are financed. In addition, Islamic banks can also apply the financing model of Ba'i As Salam as an alternative solution that equally benefits the farmers and the Islamic banking.

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