

INTEGRATING SOCIAL FINANCE INTO AGRICULTURAL BANKING: THE CASE STUDY OF MALAYSIA AND PAKISTAN

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Abstract

Agriculture continues to be a fundamental sector that necessitates sustainable development towards poverty reduction. However, the current financial services and facilities offered by the existing Islamic Financial Institutions (IFIs) are not accessible to the agricultural fraternity whose credit standing is usually not strong. This paper is primarily intended to propose potential models of innovative financing schemes that can be appropriately offered by a banking institution to the underserved group of people in agricultural sector. This study found out two pertinent issues that require further deliberation and immediate solution namely (1) Cost of Fund (COF) and (2) requirement for collateral. Thus, this study proposed potential Shari'ah compliant models of financing schemes that emphasize on (i) low COF and (ii) lack of collateral. This study found out that the above can be achieved by engaging the voluntary sector of the economy such as zakat and waqaf institution, as well as the bank's tainted income. In addition, this study would also embrace experiences of AGRO Bank in providing viable financing schemes for the small farmer which include but not limited to the schemes that involve agriculture-related organization such as BERNAS as subsidy provider, utilisation of a free deposit through government grant etc.

Keywords: Social Finance, Financial inclusion, Agricultural Banking

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Introduction

The diplomatic relations between Malaysia and Pakistan were established in 1957 where each country placed its High Commission in the other country. Such friendly relations include economic cooperation. The economic cooperation between both countries is enhanced when they entered into a Free Trade Agreement known as Malaysia-Pakistan Closer Economic Partnership Agreement (MPCEPA) on November 8th, 2007. It is then coming into force on

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January 1st, 2008. The impact of such agreement is seen in terms of liberalisation in trade in goods, services, and investment, together with bilateral technical cooperation and capacity building in several areas including sanitary and phytosanitary measures.

Further, both countries signed the Early Harvest Programme (EHP) agreement for free trade between them on October 1st, 2005. Under EHP, Malaysia and Pakistan has exchanged a number of products including agriculture products. Both countries are complementing each other as Pakistan produces quality and affordable agricultural produces while in return, Malaysia provides its expertise, the halal standards, advanced food processing establishments and more access to ASEAN trade courtesy of free trade agreements. Therefore, this paper seeks to examine the issues and challenges revolving the agricultural sector in Malaysia and Pakistan by focusing on the financing part in order to enhance these countries' agricultural sector.

Three problem statements have been pointed out in this study. First, the limitation of Islamic banking products for agricultural financing for farmers despite there are many contracts that are intended to facilitate agricultural activities under Sharī'ah such as *salam*, *muzara'ah*, *muagharasah*, *musaqah*, and others. This indicates that Sharī'ah gives emphasis on the development of agricultural sector. In the case of Malaysia, AGRO Bank for instance has initiated a financing facility based on Salam contract in collaboration with BERNAS. Secondly, financing for farmers is of high risk profile because they are people who do not have collateral and steady income but they are in need of working capital. Therefore, the issue of credit risk becomes pertinent if the bank grants financing to them. Thus, there is a need for a mechanism to mitigate the risk or transfer the risk to third party. This arrangement needs to be spelled out clearly particularly as regard parties and institutions involved. Lastly, financing for agricultural sector involves low income group whereby it is necessary for the bank to offer a financing facility with low profit rate. However, this may be impossible for the bank due to the cost of fund incurred by the bank. The issue is the need for a mechanism to reduce the cost of fund so that the bank can offer a facility at a reasonable and affordable rate. It can also offer interest free loan should it managed to secure a zero cost deposit such as government grant *etc.* This is to ensure that the bank's bottom line may not be severely affected.

Research question that arises in this study is “what are other financing facility alternatives that the bank can offer in order to secure a sustainable livelihood of the borrowers?”. In relation to the question, this paper aims to offer several models of financing facility that the banks could implement in helping those in need without burdening them with high interest rate.

This research study paper is organised in the following manner: The first section embraces a discussion on the general overview pertaining to the development of agricultural sector in Malaysia and Pakistan which includes the issues and challenges surrounding such development. The second section explicates the significant contribution of agricultural production (Food, Fishery, Agro-Based Industry, Livestock, Agro Tourism) to the economy of Malaysia and Pakistan. The third section explains initiatives and efforts in developing agricultural sector in Malaysia and Pakistan. The AGRO Bank experience in developing

agricultural sector in Malaysia is delineated in brief in section four which include the latest implementation of a strategic partnership agreement between AGRO bank & BERNAS to cater for the issue of financing in developing the agricultural sector. Section five focuses on the most significant contribution of this paper which is pertaining to alternative models that assume the feature of lower financing rate, zero cost of fund as well as no collateral involved. Section 6 conclude the discussion.

Result and Discussion

1.0 General Overview of the Development of Agricultural Sector in Malaysia and Pakistan

1.1 Developing Agricultural Sector in Malaysia and Pakistan: Issues and Challenges in Terms of Funding, Working Capital, Financing and Banking

Agricultural sector is one of the most important sectors of the component of most countries in the world, either developed or developing countries. In fact, agriculture is the primary basis for the development of all sectors and the main supplier of the sources of raw material particularly for the industrial sectors that produce food and other agro-related products. Most of the developed countries in addition to being developed industrially and technologically, they also have a developed agricultural sectors that suffice their internal needs in terms of food security and industrial inputs for the different types of goods and foods that boost their respective economy from the high revenues they earn from their exportations. Furthermore, developed countries benefiting from advanced technologies and specialisation in the different fields of agriculture, they have conquered the international markets thanks to their competitive prices and the high quality of their goods. Though one may argue in favour of the industrial and technological revolutions, in fact, it is the readily available access to low cost financing that has caused the success of their agricultural sectors. Nevertheless, emerging and developing economies besides the lack of advanced technology and developed industrial sectors, they are still incapable to fully utilise their agricultural sectors despite the potential of these sectors and their significant impacts on their economies. Indeed, there are many issues and challenges that hinders the full utilisation of this important sector. However, in this paper, we focus on the issues and challenges that are related to financing the development of agricultural sector for Malaysia and Pakistan as a case study of emerging and developing economies.

1.2 Agricultural Sector in Malaysia and Pakistan: Issues and Challenges

The Malaysian agricultural sector used to be the significant contributor in the national economy. However, its share to the Gross Domestic Product (GDP) began to decline sharply from 29.9 percent in the 1970s to around 7 percent in

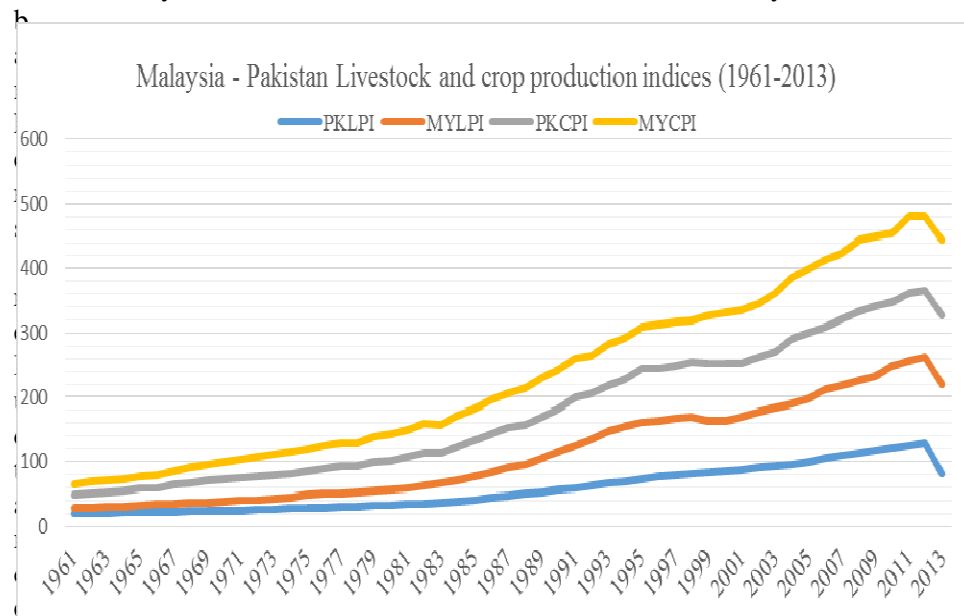
2014. The main challenges that have attributed to this significant decline are the labour shortage, increase of production cost in both agricultural inputs and capital cost and finally low productivity and quality of the agricultural produce.³ However, the major reasons for the decline in agricultural and/or agri-business sectors in Malaysia are attributed to the structural constraints, low prices of major commodities and competition in capital, land and labour with manufacturing sector (Harron, Shamsudin, & Latif, 2001). In the post-independence period of 1957 to 1970, Malaysia shifted from the normal subsistence crops to cash crops such as rubber and palm oil, and within this period and under the First Malaya Plan of 1956 to 1960, the nation's economy allocated RM478.2m equivalent to 47.5 percent of the total public development expenditure for agriculture and rural development.

Meanwhile, the government had continued its strong expenditure throughout the First, Second, Third and Fourth Malaysian Plans of 1966 to 1970, 1971 to 1975, 1976 to 1980, and 1981 to 1985. Interestingly, the outcome of these agricultural plans and programs had significantly reduced the poverty level in the rural areas from 58.7 percent in 1970 to 24.7 percent in 1984. Moreover, Malaysia emerged as the first global producer of natural rubber and palm oil by 39.8 percent and 58.8 percent respectively. Meanwhile, despite the recommendable achievements of the above Malaysian agricultural plans, it did not eradicate poverty among the traditional small holders' farmers and did not posted economic growth as expected due to the imbalances of income between the commercial and traditional farmers and the low performance of the agricultural sector due to the challenges of the favourable policies towards manufacturing, labour shortage, increased cost of production and shrinkage of land due to other sectors competition. Nevertheless, these were some of the main issues that has been addressed by the first national agricultural policy (1984-1991) when the Malaysian economy began its transformation through the expansion of the manufacturing sector.

However, these issues and challenges were addressed in the second national agricultural policy (1992-2010) by providing subsidy programs for the small holders' farmers in all sub-sectors and offering new land areas by the government for industrial crops and agro-food. Nonetheless, the agricultural challenges become more challenging such as lack of arable land, shortage of labour and efficient utilisation of resources, due to the economic structure changes that taken place after the 1997-1998 Asian Financial Crisis which again had been addressed through the two approaches of the third national agricultural policy (1998-2010). Due to some of the persistent problems such the competition for land with other sectors, shortage of labour supply and the increased cost of production in addition to climate change and further enhancements in quality and affordability, Malaysia has already initiated its

³ Rozhan Abu Dardak, *Transformation of Agricultural Sector in Malaysia through Agriculture Policy*, MARDI, Retrieved from http://ap.fftc.agnet.org/ap_db.php?id=386.

fourth national agro-food policy (2011-2020) in order to address these issues and further make the agricultural sector more modern and dynamic through strengthening of human capital and the use of modern technology and mechanization besides incentivizing private sectors to invest in the agriculture and agro-based industry (Dardak, 2015). Another major issue for the case of Malaysia is the inadequate financial assistance that provided to the independent smallholders palm oil producers who do not fulfil the minimum requirement of collateral to get access to financing to cover the high costs of material inputs such as fertilizers, seedling, harvesting, transportation and risks of crop price fluctuation (Ador, Shafiai, & Ismail, 2014)⁴. Nevertheless, with regards to the paddy in spite of the continuous government support since the 1966-1970 Malaysian Plan to the recent 10th Malaysian Plan, rice production is still considered inefficient in terms of cost and quantity of production (Fahmi, Samah, & Abdullah, 2013). Moreover, besides the issue of interest in the credit financing, it was found by (M. H. M. Shafiai & Moi, 2015) that the involvement of the Malaysian farmers with financial institution to be very low because of



to offer financing to small farmers, fear of loan repayment, informal financing and expectation of governmental organizations supports.

Graph 1: Malaysia-Pakistan Livestock and Crop Production Indices (1961-2013)

⁴ - Proceedings PERKEM ke-9 (2014).

Source: World Bank – World Development Indicators

The above graph depicts a clear picture of the rise of the indices of livestock and crop production in Malaysia and Pakistan for the period of five decades that span from 1961 to 2013 shortly after the independence of both countries. As we can observe, both of the indices in both countries from less than 100 points in the first decade, they have shown a slight increase till the end of the third decade in the 1991, after which there was a significant growth until the fifth decade with slight falls in the end of the fourth decade. However, as we can see from the above graph of both of the indices, Malaysia's indices of livestock and crop production have performed better than the Pakistan's indices since the beginning of the fourth decade. This graphs, despite the vast differences between the agricultural land between the two countries, portrays clearly the efforts and the agricultural policies and strategies that Malaysia has adopted in its agricultural sector since 1981. Finally, while the Malaysian crop production index rapidly grew from 50 points in its first decade to 450 points in the last decade compared to the livestock index that grew moderately from the same points to 250 points 2012 after which both of the indices stated falling. Meanwhile, in the case of Pakistan while the crop production index has shown similar rise to that of Malaysia but quite lower by 100 points, the livestock index, however, has grown to half of that of Malaysian livestock production index i.e. 125 points.

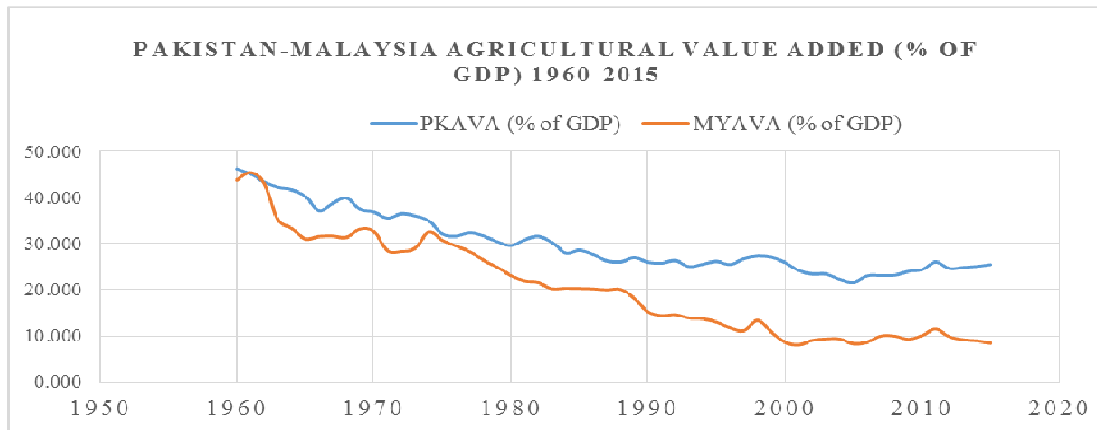
In Pakistan, agricultural sector is the most important sector, and it contributes 20.9 percent to GDP besides employing 43.5 percent of the country's labour force. It comprises five sub-sectors which are major crops, minor crops, livestock, fishery, and forestry. However, the livestock sector is the back bone of the whole agricultural sector and it contributes 56.3 percent of the value addition in this sector. Meanwhile, Pakistan is the third largest milk producer in the world following India, China and the USA, and the fourth largest cotton producing country in the world following the same countries (Chandio et al., 2015). In addition to the common problems and issues, the agricultural sector in Pakistan also faces the major problem of credit financing due to the lack of collateral in addition to the rough loaning procedure strict repayment conditions thereby the inability of accessing the formal credit institutions for agricultural credit particularly in northwest Pakistan (Jan, Munir, Usman, & Idrees, 2012). It was also highlighted by (Mehmood, Ahmad, & Anjum, 2012) that the delay in repayment of agricultural credit in Pakistan was found to be due to the reasons of careless supervision by bankers, mis-utilisation of loans, higher interest rates and change of borrowers' business

and/or residential location. Nevertheless, in addition to the above issues, it is documented in the literature that other factors that pose challenges are those that have high impacts on the credit demand of the agricultural sector such as climate change, interest rate, investment in the micro irrigation system and the farmers' credit worthiness (M Taimoor Hassan et al., 2012). Moreover, the agricultural sector productivity in Pakistan is low because of the substandard quality of seeds/pesticides/fertilizers, unavailability of the required water and machinery, crop diseases, unavailability of transport and lack of technical guidance. Besides that, old traditional way of cultivation and the tedious procedures of taking loans from the banks, in addition to the huge burden of debt on the majority of the farmers (Kaleem & Abdul Wajid, 2009).

2.0 Significant Contribution of Agricultural Production (Food, Fishery, Agro-Based Industry, Livestock, Agro Tourism) to The Economy of Malaysia and Pakistan

Although Malaysia has succeeded in achieving a significant increase in some of the basic foods such as rice, fruits, vegetables, fisheries and poultry, it is yet dependent on the importation of some other basic food items such as wheat, beef, mutton and dairy products due to the relatively limited local production and high demand. Nevertheless, the agricultural sector has a considerable contribution in the economy either in achieving self-sufficiency or generating hard currency revenues from exportation. However, the self-sufficiency programme mainly concentrates on the production of rice which accounts for 86 percent of Malaysia's food grain production and as one of the most important source of employment in the rural area. Nonetheless, the agricultural sector in Malaysia is dominated by palm oil, rubber and forestry products. Furthermore, it is documented that poultry is the most viable livestock industry in Malaysia due to its higher productivity and standards (Ahmed & Siwar, 2013). Interestingly, empirical evidences of the short and long-run relationship between the industrial and agricultural sectors is still existing in which the industrial sector reveals to have impacts on the agricultural sector (Matahir, 2012). In fact, the contribution of the agricultural sector to the Malaysian economy from 1970s regardless to agriculture-led economic policies and strategies. It was found by (Matahir & Tuyon, 2013) that both economic growth and agricultural sectors to have bi-directional causality movement in the long-run which clearly indicates the interdependence of economic growth and agricultural productivity which confirms the unbiasedness of government policy to either of the industrial or agricultural sectors as documented by (Zakiah Ahmad, Abdul Majid, & Azlan Shah Zaidi, 2001).

Graph 2: Pakistan-Malaysia Agricultural Value Added (% of GDP) 1960-2015



Source: World Bank – World Development Indicators

The above graph compares the agricultural value added as percentage of GDP for both Pakistan and Malaysia for the period of 1960 to 2015. Interestingly, from the value added of 45 percent of GDP for both countries in 1961, the value sharply dropped to 25 percent and 15 percent in the 1990s respectively. However, while Pakistan has still kept the value added 25 percent of GDP in 2015 after slight ups and downs movements since 1991. In Malaysia, however, the value added of GDP has significantly dropped to 8 percent for the same year i.e. 1991. The information conveyed with this graph makes an economic sense due to the increased value added from the manufacturing and service sectors to the Malaysian economy.

In the case of the Pakistan's economy, it is empirically proven that the agricultural sector is the most important sector compared to the other two major sectors, manufacturing and service industry, that significantly affect the annual GDP growth of Pakistan since its independence in 1947 (Nazish, Iqbal, & Ramzan, 2013). In assessing the significant contribution of the agricultural sub-sectors to the economic growth of Pakistan, (Syed Ali Raza, Ali, & Mehboob, 2012) found that crops and livestock combined are found to contribute significantly of about 91 percent of the aggregate agricultural sector while fisheries and forestry only have minimal contribution due to some major that related to low investment intensity, insufficient facilities as well as the issue of untrained and unskilful labour force of these sectors. Interestingly, the recent Pakistan agricultural sector contribution to the GDP was estimated to be 23.4 percent, which clearly substantiates the strong relationship between them. Most importantly, the main role of the agricultural sector in Pakistan is to minimize poverty, provide unemployment and diversification from self-reliance to profitability. However, in Pakistan up to date, there are 3950 bank branches that offer agriculture credit to farmers with only three Islamic banks involved (Usman, 2016). It is worth mentioning that while the conventional mark-up rates in Pakistan ranges from 15 to 20 percent in Pakistan, Meezan bank is the first Islamic bank which has initiated the fully Shari'ah compliant agri-financing under the Murabaha financing contract (Saeed et al., 2013).

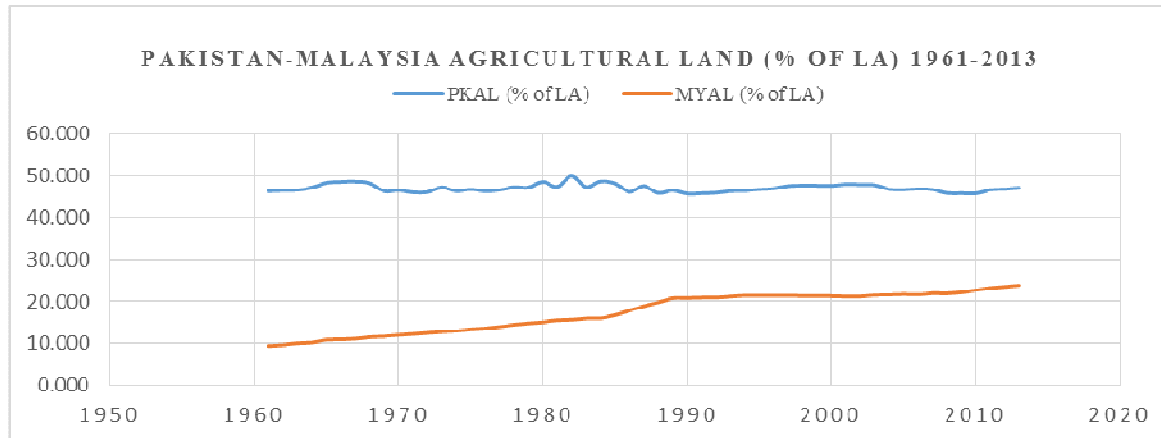
3.0 Initiatives and Efforts in Developing Agricultural Sector in Malaysia and Pakistan

One of the main challenges and issues highlighted in the previous literatures is the problem of financing poor farmers particularly in the rural areas. The conventional financing system that based on interest rate has already proved its insignificance in the agricultural sector. Meanwhile, government and donors' subsidies for poor farmers to cover their interest payment expenses and defaults has also ended in failure and raised another major problems of unhealthy dependency on subsidies and thereby an inefficient low productivity. Nevertheless, with the evolution of the 1980s microfinance, many governments have supported them to finance the rural agricultural development which was not very much successful despite some improvements due to the lack of experience and expertise. Hence, according to (M. H. B. M. Shafiai)⁵ if good initiatives are taken, there are many feasible possible opportunities to exists and offer interest free financing to rural farmers to finance their working capital and the non-crop needs such as buying seeds, fertilizers and pesticides as well as to pay their electricity and water bills. However, the proposed Islamic micro-finance vehicles can obtain funds from the waqaf and Zakat institutions using the feasible Islamic contracts of Mudarabah and Muzara'a. The Islamic agricultural finance for the rural poor farmers has already proven to be successful using the tripartite model of the integration of the philanthropy-based, not-for-profit and for-profit financing model in Sudan (Obaidullah, 2015). Some of the major initiatives and efforts in developing the Malaysian agricultural sector is undertaking under the research funding in the 10th Malaysian Plan (2011-2015) under the auspices of the government ministries (Rahman, 2012). First, the ministry of science technology and innovation provides research grants such as Science Fund, Technology Fund and Innovation Fund in the form of enterprise and community. Second, the ministry of higher education fundamental, exploratory, long-term and prototype research grant schemes. Finally, the research university grant schemes that has been initiated by the ministry of higher education which provides financing to a large number of projects under the five research leading Malaysian universities. Moreover, Malaysia is taking the initiative to accomplish five specific targets in the 9th Malaysian Plan which includes generating a value added growth of 7.6 percent and 5.2 percent in the agro-based industry, a surplus of RM 1.2 billion in food trade, attracting investment from the private sector and achieving self-sufficiency level of various documents. Hence, it has set an encouragement and incentive schemes under the development funds of the LKIM fishermen funds, Techno fund and science fund as well as the fiscal and non-fiscal incentives.⁶

Graph 3: Pakistan-Malaysia Agricultural Land (% of LA) 1961-2013

⁵ Proceedings PERKEM ke-9 (2014).

⁶ <http://www.moa.gov.my/en/agensi-polisi>.



Source: World Bank – World Development Indicators

The above graph shows the Pakistani and Malaysian agricultural land (sq.km), and the agricultural land as percent of the lands of both countries for the period of 1961 to 2013. In the 1960s, the total agricultural land in Pakistan and Malaysia was 357300 sq.km and 31185 sq.km while the agricultural land as percent of the land was 46 percent and 10 percent respectively. Nevertheless, in the 1990s, while there was no change in the case of Pakistan for the agricultural land as percent of land. In fact, the percentage in Malaysia has doubled to 21 percent due to the double increase in the agricultural land i.e. from 31185 sq.km to 68457 sq.km. Finally, in 2013, Pakistan has only increased to 47 percent whereas Malaysia slightly went up to 24 percent due to the 9933 sq.km increase of the agricultural land.

Even though Pakistan economy is an agricultural lead economy, empirical research has shown that financial liberalization has a positive effect on the agricultural growth both in the short and long-run, in contrast to interest rate which affects the Pakistani agricultural growth negatively in the long-run (Muhammad Adnan Hye & Wizarat, 2011). Meanwhile, it was also confirmed that financial development and agriculture growth have long-run relationship and bi-directional causality which clearly indicates the significant role of the financial development (Shahbaz, Shahbaz Shabbir, & Sabihuddin Butt, 2013). Nevertheless, due to the long-term negative impacts of interest rate, the relationship between the Islamic banks and the agricultural sector in Pakistan has become significant in providing easy financing under its diverse contracts such as *Ijarah*, *Diminishing Musharaka*, *Murabahah*, *Salam*, *Musawamah* and *Muzara'a* which substantially increases the asset ownership, yield and income of the farmers. However, the main issue is that Islamic banks are not offering any form of financing for the irrigation system which makes farmer encounter problems of credit standing and collateral (Muhammad Taimoor Hassan et al., 2012). However, recent study by proposes the utilisation of *Qard hassan* as one of the viable option of financing poor farmers in the agricultural sector which is also deemed to be beneficial as well to the Islamic banks and financial institutions (Saqib, Zafar, Khan, Roberts, & Zafar, 2015). Finally, Pakistan has also set the national flagship programs that have technological component for the remote to address the challenges and high priority national issues based on the high risk and high return policies.

4.0 Agro Bank's Experience in Developing Agricultural Sector

Agrobank is formerly known as Bank Pertanian Malaysia which has 40 years of experience in agricultural banking and an excellent track record in developing successful entrepreneurs. It was established with the mission is to provide a holistic range of financial services and banking facilities with emphasis on the agricultural sector. Currently, AGRO is offering a range of Islamic banking products and services such as Hartani-I, Strategic Alliance Financing-i (SALF-i), Paddy-i, MUSIM-i *etc.* AGRO Bank has products that are based on strategic alliance such as the one launched recently where it is based on strategic partnership with BERNAS. Thus, this paper would focus on this product as a successful instance of AGRO Bank initiative to assist the farmers.

4.1 A Proposal for The Implementation of a Strategic Partnership Agreement Between Agro Bank & BERNAS

Padiberas Nasional Berhad (BERNAS) involves in the procurement and processing of paddy, together with the importation, warehousing, distribution, and marketing of rice in Malaysia. It is committed to the continued growth in the local rice industry. Meanwhile, AGROBANK is established with the mission to provide a holistic range of financial services and banking facilities with a focus on the agricultural sector. As both of these institutions' objectives are complementary, they proposed to implement a Strategic Partnership Agreement (MOU) between them.

There is a proposal to implement a Strategic Partnership Agreement (MOU) between Padiberas Nasional Berhad and AGROBANK. As a company involves with the development of paddy and rice industries, BERNAS offers financial assistance to the farmers who have registered under Plantation Partnership Program or *Program Rakan Ladang* (PRL). Under PRL, the farmers who have registered as a member agree to sell the paddy yield to BERNAS and in return for that, BERNAS will provide advance assistance in terms of cash money.

The agreement is proposed as BERNAS wishes to channel all the fund for the farmers to AGROBANK, in which the latter acts as the main financing source. Hence, AGROBANK will provide credit financing facility (*Paddy-i*) to the qualified participants of PRL BERNAS. Basically, the proposed structure for such Strategic Partnership Agreement is illustrated in the following diagram:

Figure 1: Proposed Structure of Strategic Partnership Agreement



Under this Agreement, all parties will play their own role, namely:

A) BERNAS:

- I. To submit the list of all participants of PRL BERNAS to AGROBANK for the purpose of financing.
- II. To open savings account with AGROBANK.
- III. To channel the revenue including related subsidies payment into such savings account of PRL BERNAS's participants with Agrobank.

B) Agrobank:

- I. To evaluate and consider the application of Financing Facility according to AGROBANK's current policy.
- II. To provide financing facility for paddy to the qualified participants of PRL BERNAS.

C) Participants' of PRL:

- I. Responsible to sell any revenue from the production of paddy to BERNAS.

The proposed agreement may be terminated in two ways. Firstly, when all the Financing Facility issued to the participants of PRL BERNAS are fully paid. Secondly, through 6 months' written notice (which is equivalent to 1 season of paddy's cultivation) given by a party who wish to terminate the agreement to the other party. No modification, amendment, or waiver of any provision of such agreement shall be effective except it is made by mutual consent in writing through an additional agreement which refers specifically to the current agreement and signed by the representatives duly authorized by BERNAS and Agrobank.

4.2 Sharī'ah Issues

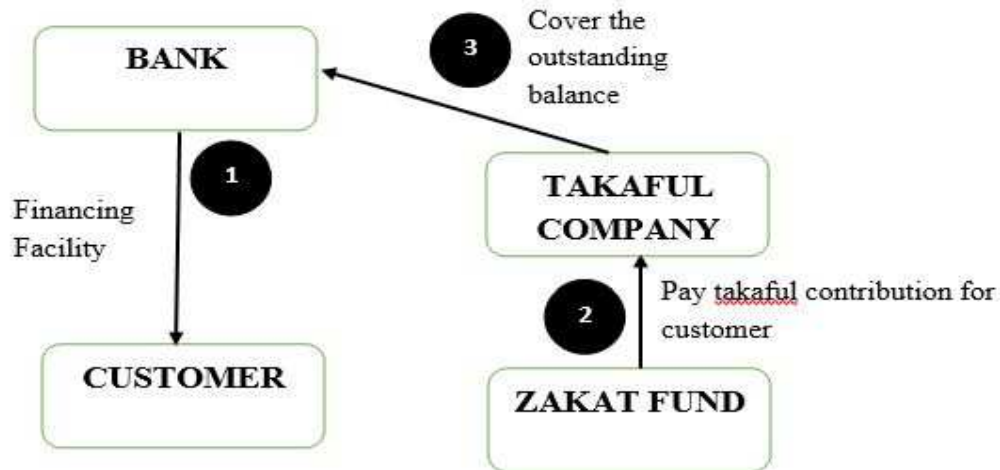
With regards to the abovementioned agreement, the Sharī'ah issue discussed is related to one of clauses in the agreement. It stipulates that “*The participants of PRL BERNAS have given an irrevocable consent to BERNAS to make any deduction from the paddy’s revenue to Kilang Beras Bernas and to channel directly such revenue and subsidies from the production of paddy into the savings account of the participants with Agrobank*”. This clause, which is related to the consent given by the participants for the deduction, has to be inserted in the financing agreement on the ground that the money transferred into such account belongs to the participants and therefore consent from them is needed to make such deduction. The amount of money that has been transferred into the savings account of the participants will be used to set off the participants’ debt with the bank on the basis of *muqasah* and the remaining belongs to the participants for their use. The insertion of such clause in the financing agreement is in line with the requirement under the Strategic Partnership Agreement where BERNAS as the party who made payment for the yield of the paddy or the subsidies’ payment will channel such money to the Bank directly into the savings account of the participants’ of the PRL with Agrobank.

5.0 Other Alternatives

The following models can also be considered to provide financing facility to the small farmers whereby the profit rate charged to the customer is lower than the normal financing rate or there will be of no charge for example in if the financing is based on *qard*.

First model: Utilisation of zakat fund to cover payment of takaful contribution for credit takaful for zakat beneficiaries

Figure 2: Proposed Model for Utilisation of Zakat Fund to Cover Payment of Takaful Contribution for Credit Takaful for Zakat Beneficiaries



Under this model, the operation will be as follows:

- 1) The bank would provide financing facility to the eligible customer who is in need.
- 2) The zakat fund would be utilised to pay takaful contribution subscribed by the customer who falls under the category of zakat beneficiaries particularly *masakin* and *fuqara'*.
- 3) In the event of customer's failure to meet his financial obligation *i.e.* due to permanent disability or death or other factors, the outstanding balance of the financing amount will be paid form the takaful fund.

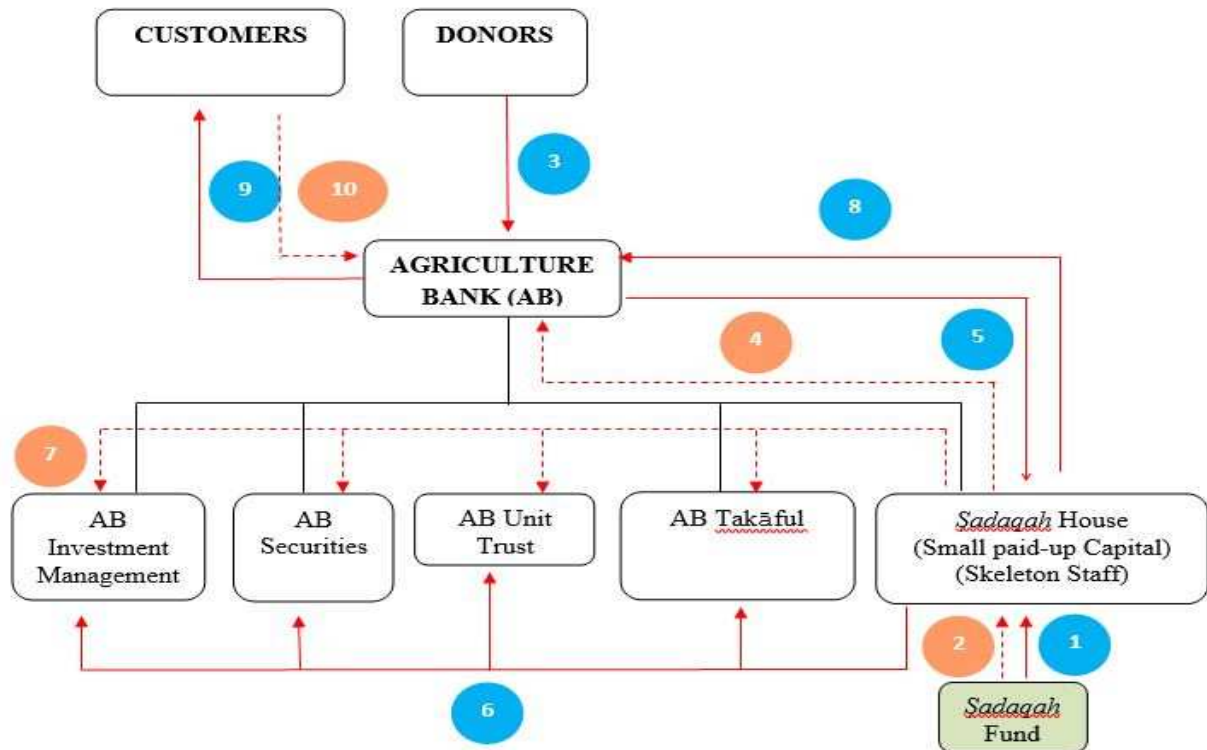
However, there is an issue as to the number of takaful operator who is willing to participate in this programme. There might be not many takaful operators who will join this programme due to several reasons. Apart from that, Sharī'ah issue might arise as to the Sharī'ah ruling on utilisation of zakat fund for the above purpose.

Second model: Utilisation of donation fund to part finance the lower income group

This model is originally developed from the idea of Sadaqah House propounded by Dato' Abdul Halim Ismail Award Recipient of the Royal Award for Islamic Finance 2014 At the GIFF 2014 as spelled out in his Public Lecture.

Under this model, the donation fund will be operated as follows:

Figure 3: Proposed Model for Utilisation of Donation Fund to Part Finance the Lower Income Group

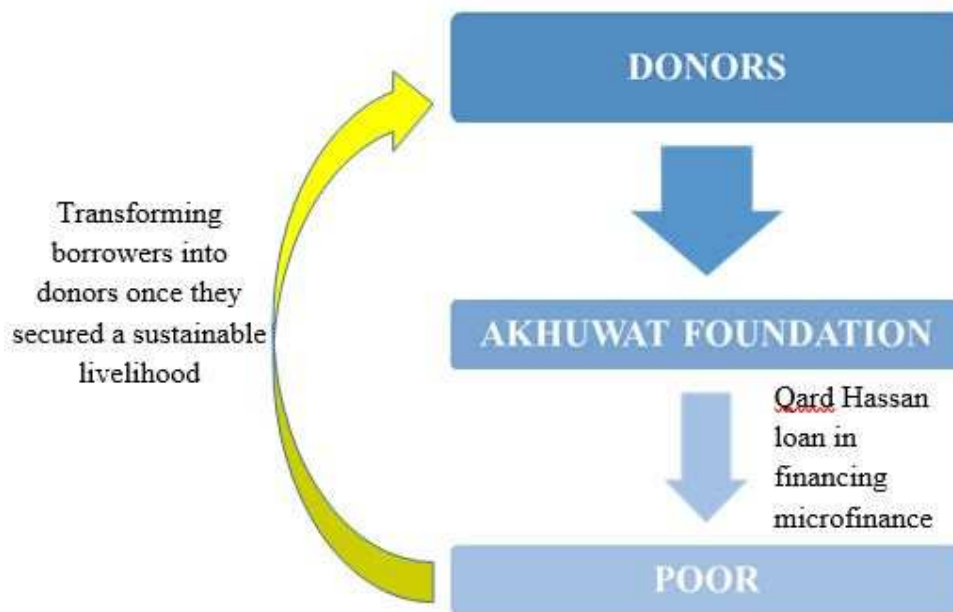


- 1) Şadaqah Fund (SF) in its capacity as legal entity (*shakhşiyah itibāriyyah*) appoints Şadaqah House (SH) as its trustee / wasi / wakil to manage and maintain the fund.
- 2) SF pays wakalah fee to SH for managing and maintaining the donation fund and the interest of the donors.
- 3) Agriculture Bank (AB) as wakil to SH receives Şadaqah, waqf, and other types of Islamic social finance from donors as well as AB's tainted income, on behalf of muwakkil (Şadaqah House-SH). The SH may have its own account with AB for donation placement. AB may charge reasonable wakālah fee / service charge for managing and maintaining the SH account in addition to services rendered to the SH.
- 4) SH pays wakalah fee to AB for managing the donation fund at fund mobilization stage which includes collection of fund through various channels and mechanism and fund distribution stage which includes disbursement of fund to the designated beneficiaries.
- 5) AB passes on the donation to SH at the end of every month.
- 6) SH makes various investment which results in obligation to pay various fees and charges to the respective investment parties under AB's Group etc.
- 7) SH pays relevant fees and service charges to AB Investment Groups for investing the fund in various investment portfolios to generate return.
- 8) At end-year or end-month SH passes return from investment of the donation fund to be distributed to AB.
- 9) AB distributes such return of the donation fund to the eligible customers *e.g.* the lower income group in financing their business.

10) Customers will pay back to the bank on the specified date as agreed upfront. The amount that the customers should pay is based on the types of facility that they entered into. The first type is normal banking facility such as Commodity *Murabahah* where the customers have to pay back based on the selling price. On contrary, the customers will pay back at zero interest rate if the facility is *qard hassan*.

In Pakistan, Akhuwat Foundation is an excellent example that has similar mechanism where they offered interest free loans to the economically poor in microfinance based on the principles of *qard hassan*. The purpose is to acquire a sustainable livelihood of the customers. The model of Akhuwat Foundation is as follows:

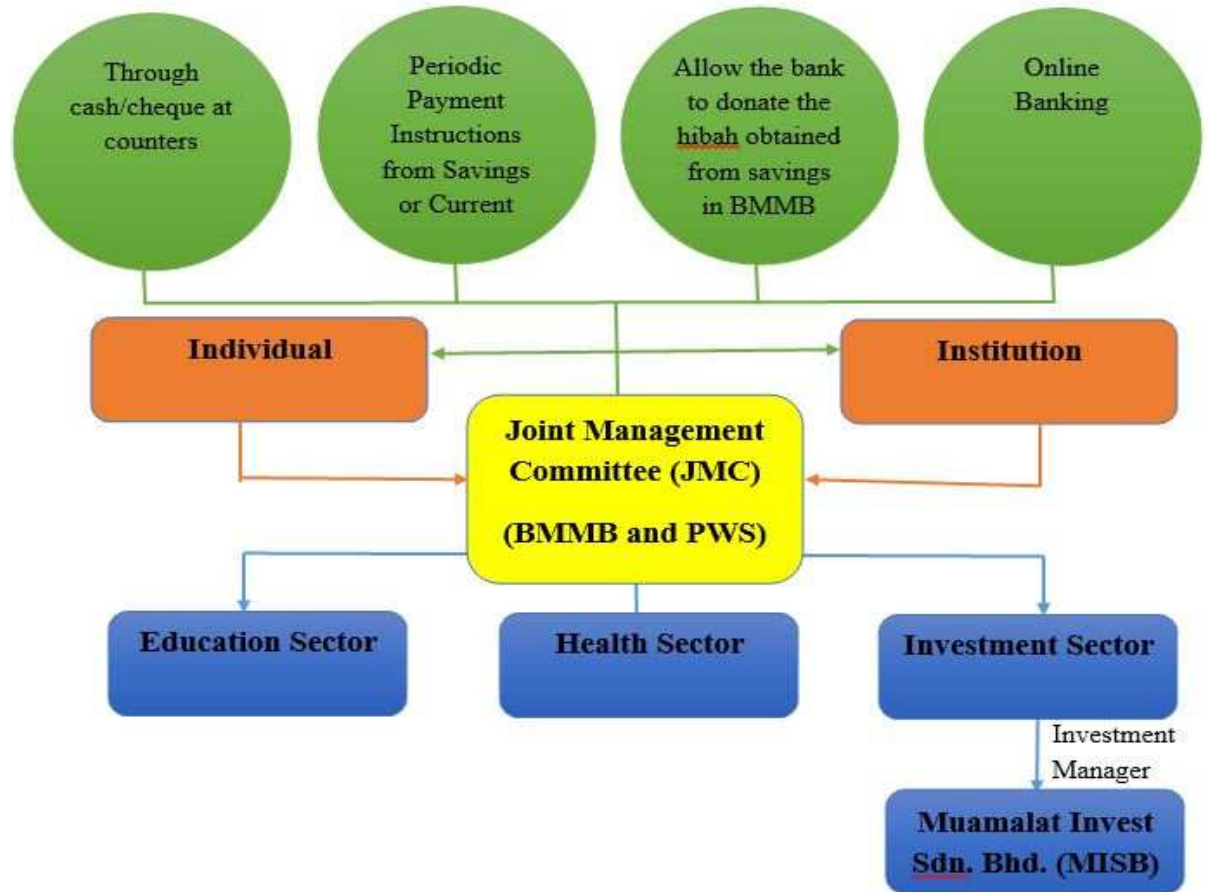
Figure 4: Model of Akhuwat Foundation



In terms of collection of donation fund mobilization, it is suggested that the banking infrastructure be leveraged such as the one applied by Bank Muamalat Malaysia Berhad (BMMB) in collaboration with Perbadanan Wakaf Selangor under the name of “Wakaf Selangor Muamalat”, a corporate waqf model jointly established by Perbadanan Wakaf Selangor (PWS) and Bank Muamalat Malaysia Berhad (BMMB), can be implemented under this model. One of them is through *hibah* from the donors’ *wadi’ah* account with BMMB apart from paying it in cash or through cheque. Under this method, the donors’ (the bank’s customers) will give permission to the BMMB to channel part of the *hibah* received from their *wadi’ah* account to the

waqf fund. The financial and operational structure for Wakaf Selangor Muamalat is as follows:

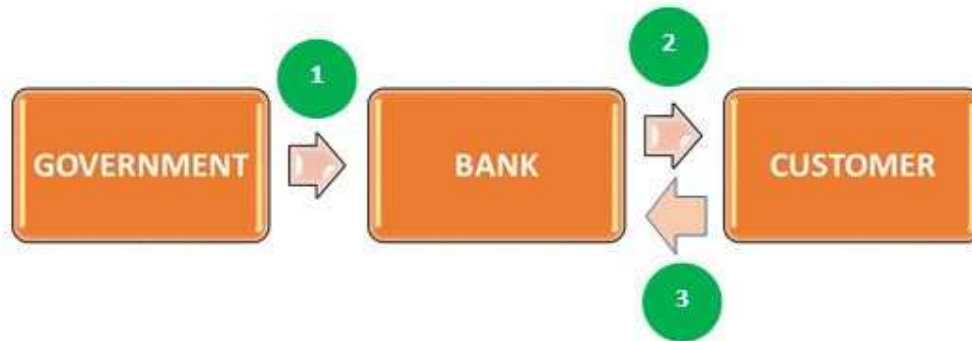
Figure 5: Financial and Operational Structure for Wakaf Selangor Muamalat



However, this model is subject to two issues and challenges. The first issue and challenge is pertaining to the status of the fund whether it is being operated based on the Shari'ah principles or not. Meanwhile, the second issue and challenge is with regard to the sustainability of the fund. It is questionable as to whether the donation fund will sustain if the principal amounts of donation are being used to finance the eligible customers, instead of using the return from the investment of such principal amounts. In this case, the donation fund will not last long.

Third model: Utilisation of zero cost deposit to finance the lower income group at lower rate

Figure 6: Proposed Model for Utilisation of Zero Cost Deposit to Finance the Lower Income Group at Lower Rate



Under this model, the donation fund will be operated as follows:

- 1) The bank receives fund from government without cost whereby the bank is mandated to channel the fund to the target group of potential recipients.
- 2) The bank would channel such fund to the eligible customers as financing facility.
- 3) Customers will pay back to the bank at lower/zero rate on the specified date as agreed upfront. This is because the bank does not incur any cost of fund when receiving it from the government.

However, this model is subject to two issues and challenges which are in terms of operation and in terms of Shari'ah. In terms of operation, the government as provider of grant may from time to time either cease the scheme or expect a return on the allocated fund. Consequently, the financing facility given to the eligible customers will be reduced or the customers will have to pay back the financing facility at a higher rate in which they may not afford to do it. For the issue related to Shari'ah, there is no issue which is in conflict of Shari'ah as the structure is very straight forward and that it is based on Shari'ah-compliant structure endorsed by the respective Shari'ah committee.

Conclusion

The issues and challenges revolving the financing facility in agricultural sector in Malaysia and Pakistan has been one of the constraints in developing such sector. Since the issue has yet to be resolved, this study attempts to analyse this issue from the perspective of the bank by proposing several models to utilise the donation fund to the eligible customers. It is found that the utilisation of the donation fund can be in three forms, namely utilisation of zakat fund to cover payment of credit takaful for beneficiaries of zakat, utilisation of donation fund to part finance the lower income group, and utilisation of zero cost deposit to finance the lower income group at lower rate. This study also identifies the strategic partnership agreement between BERNAS and AGRO bank in developing the agricultural sector by giving financing facility to the eligible customers. Therefore, it is important to urge the banks in Malaysia and Pakistan to implement this new initiative in maintaining the importance of agricultural sector

in both countries. It is also submitted that there is an urgency to move forward by cooperating with the institutions/agencies that are involved with agricultural sector to develop such sector together as the work done by every person involved is more efficient and effective.

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