Food and Agriculture Organization
of the United Nations

ALTERNATIVE AGRICULTURAL LIVELIHOODS PROGRAMME
AFGHANISTAN

GCP/AFG/036/UK

Financing Seasonal Crops: A Proposal for *Bai Salam* in Afghanistan

Project Discussion Paper 19

October 2006

MAAHF

DFID Department for International Development

Authorship

This paper was prepared by Ralph C. Houtman, Regional Marketing and Rural Finance Officer, FAO Bangkok, for the Alternative Agricultural Livelihoods Programme (GCP/AFG/036/UK).

Final editing was carried out by Andrew Weir (AndrewRobert.Weir@fao.org), the Chief Technical Advisor of the Alternative Agricultural Livelihoods Programme, and David Hitchcock (David.Hitchcock@fao.org), Senior Agricultural and Infrastructure Officer, FAO Bangkok.

Contacts

Hard copies of this document can be obtained from AALP: FAOF-AALP@fao.org.

Soft copies can be downloaded from the AALP Website: www.FAO-AALP.org

Alternative Agricultural Livelihoods Programme
Food and Agriculture Organization of the United Nations
Sanatorium Road
Darulaman
Kabul
Afghanistan

Disclaimer

Table of contents

List of abbreviations

AALP	Alternative Agricultural Livelihoods Programme, FAO
Af	Afghani (approx. 50 Afs = 1 US$)
ARMP	Afghanistan Rural Microfinance Program
BRAC	Bangladesh Rural Advancement Committee
FINCA	Foundation for International Community Assistance
GTZ	Gesellschaft für Technische Zusammenarbeit (German Technical Cooperation)
IFDC	International Fertilizer Development Center
MFI	Micro-Finance Institution
MISFA	Microfinance Investment Support Facility for Afghanistan
NGO	Non-governmental Organisation
PLS	profit and loss sharing
WOCCU	World Council of Credit Unions

Summary

Bai salam is an ideal product to finance seasonal crops in Afghanistan. From the farmers' perspective the system provides cash when needed and allows repayment in kind when the crop is harvested. Also, *bai salam* is fully *sharia* compliant and will not face resistance on religious grounds.

From the donors' perspective, *bai salam* channelled through wheat processors, such as flour mills, is a more efficient way to disburse credit than *bai muajjal* or *murabaha* channelled through input dealers. This is because wholesale lenders such as the Microfinance Support Facility for Afghanistan (MISFA), can lend directly to large wheat mills which in turn, can on-lend to farmers. MISFA and donors cannot deal directly with thousands of small input dealers, and therefore an intermediary would be necessary to support a large-scale credit programme.

Finally, because of economies of scale and efficiency achievable with the wheat mills as partners, *bai salam* would require less investment in capacity building than *bai muajjal* or other schemes that operate through input dealers.

A shortage of appropriate seasonal (and long-term) credit for licit agricultural crops is one of the main reasons given by farmers for growing opium poppy—for which *bai salam* credit is readily available[1]. Increasing the availability of credit in rural areas is one of the key components of the enabling rural environment that will need to be established if opium poppy growing is to be reduced sustainably in Afghanistan.

Introduction

In mid 2006, about 200,000 households in Afghanistan had access to micro-credit services. These services are available from a number of micro-finance institutions (MFIs), of which BRAC, ARMP and FINCA are three large operators. Many MFIs receive finance from the donor supported wholesale financier, MISFA. Assuming that there are four million eligible households in Afghanistan, the outreach of about 200,000 loans, so far achieved by MISFA and its network of MFI-retailers, would mean that about five percent of the potential target group has been reached. In view of the infancy of the industry[2] and the challenging environment, this is a notable achievement.

Most of the MFI borrowers live in peri-urban and rural areas and it appears that more than half of all microfinance loans disbursed are for agricultural purposes.

This paper first discusses two identified shortcomings in the current supply of credit to farmers in Afghanistan and then proposes a solution to address these shortcomings together with a strategy for the accelerated expansion of seasonal agricultural credit.

Shortcomings of current loan products

Two shortcomings have been identified.

Loan schedules do not match cash flow requirements of seasonal crops

Although the MFIs in Afghanistan provide more than half of their loans for agricultural purposes, very few of these funds are being lent in a form that is suitable for financing the main seasonal crops such as wheat or potatoes (see box). This is because the disbursement and repayment schedules for the agricultural loans do not match the cash flow needs of such crops. However, part of this seasonal agricultural credit is being used for animal husbandry or perennial crop activities such as orchards.

> Potatoes are mentioned because Bamyan province was visited as part of the mission reviewing the agricultural finance sector. In this paper, wheat is used as an example, but in a number of small areas, potatoes are an important crop. When improved, commercial storage is available for potatoes, *bai salam* could also be pilot-tested through potato stores.

[1] See, for example, AALP Project Discussion Paper 20
[2] MISFA has been operating since 2003, most MFIs have been operating since 2004

The charts in Figure 1 compare the financing requirement for wheat, the main staple crop, and the cash flow provided by the typical MFI loan.

The provisions of a loan product that perfectly matches the cash flow requirement of a wheat farmer should follow the chart on the left. However, most of the loan products, currently on offer, provide a cash flow pattern similar to that in the chart on the right[3].

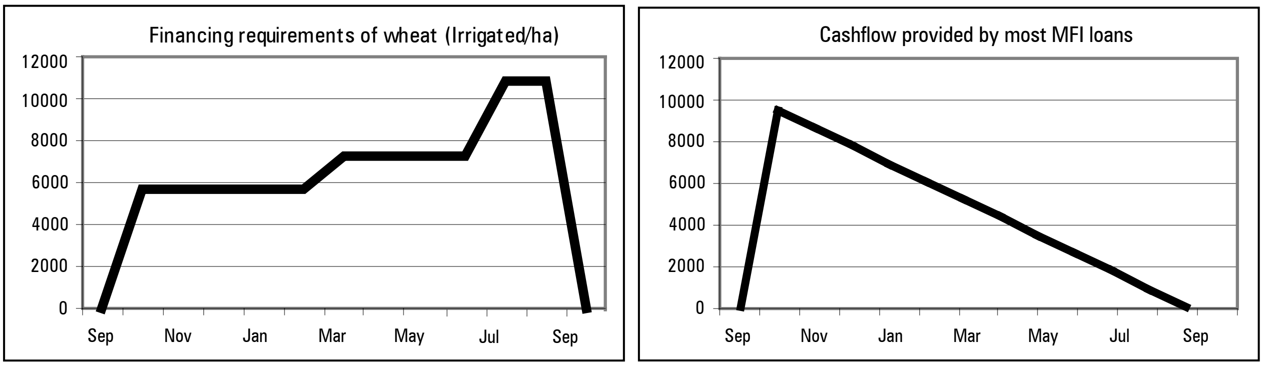

Figure 1. *Mismatch between finance required (left) and offered (right) by most MFI loan products (Afs.)*

Loan products do not meet Islamic financing *sharia* requirements

The loan products and their parameters (service charges, rates, repayment schedule) are currently not compliant with Islamic *sharia* law as it is supposed to be practiced in Afghanistan. Although all MFIs have introduced the phrase 'service charge' to replace the word 'interest', it is clear that the actual formulas used to calculate the service charges, are the same as those normally used for the calculation of (in most cases) flat interest. In less strict Islamic societies such as Bangladesh or Indonesia, such simplification has proven to be acceptable for the majority of people; but in more conservative countries like Pakistan, Iran and Afghanistan, there is resistance. This not only hinders the outreach of the MFI programmes, but potentially creates unnecessary friction within communities and between communities and MFIs.

One key challenge in designing a *sharia*-compliant loan product is that the service charges should not be a function of the loan amount or of the duration of the loan. This limits the options to those loan products which have a fixed and flat service fee (regardless of the loan amount and duration), or to products which are basically trade or investment contracts.

Reasons for the neglect of crop financing

Seasonal crop finance is not the strongest aspect of the global microfinance industry. Most micro-finance methodologies require borrowers to pay back loans from a regular and steady source of income such as a village shop, petty trading or the famous milking cow. The income source needs to be either pre-existing or financed with the loan.

MFIs prefer such repayment schedules because the schedule itself is a good mechanism to monitor the performance of the borrower and the project funded by the loan. Seasonal crops, such as wheat or rice, cannot provide this steady source of income, and therefore they do not feature much in the methodologies and loan products of most MFIs.

Of course, there are other reasons why MFIs tend to neglect agriculture. The associated risks are relatively high; and lending to agriculture requires skills and experience which most MFIs do not have readily available.

Naturally, when international MFIs were encouraged to establish their operations in Afghanistan, they tended to introduce methodologies and products that they had tested and

[3] The only MFIs that have a product matching the requirements of seasonal crop farmers are the two WOCCU initiated credit unions in Balkh and Jawzjan provinces.

proven elsewhere. Consequently, they introduced the bias against financing seasonal crops that exists in other parts of the world.

Reasons for non-compliance with sharia

As the international MFIs introduced their methodologies and products, another aspect of credit that became neglected was compliance with Islamic *sharia* law. Although all MFIs dropped the word 'interest', and in most cases replaced it with 'service charge' or an equivalent phrase, these service charges retained a strong resemblance to interest because, in most cases, the charges are calculated on the basis of the loan amount and the duration of the loan.

One of the larger MFIs, FINCA, has announced that they will make their loan products *sharia*-compliant by adopting the *murabaha* contract. Under *murabaha*, a trader buys at a certain cost and then adds a mark-up (profit). The buyer usually pays in instalments. One of the requirements for this type of contract to be *sharia*-compliant, is that there should be two separate and real transactions:

- a purchasing transaction by the MFI, and
- a second transaction whereby the MFI sells the goods to the client.

In Pakistan, fictional transactions have been rejected by *sharia* courts as un-Islamic. It remains to be seen if FINCA's methodology will be acceptable to religious leaders in Afghanistan. This will depend on whether or not certain transactions are interpreted as fictional.[4]

Islamic financial products

Sharia-compliant Islamic finance does not allow lenders or borrowers to charge, or savers to earn, interest. The financier is allowed a good return on his money, but this should be earned by sharing a certain part of the risk with the borrower or investor and/or by providing additional services. There is therefore no pure lender as such, because the *sharia* lender takes on the role of a co-investor, trader or entrepreneur, who operates under various risk-sharing or profit sharing, or profit and loss sharing (PLS) arrangements. Typically, *sharia*-compliant Islamic financiers take on much more risk than western-style banks.[5]

In modern-day finance, there remain a number of unresolved issues that hamper the full conversion of a western-style banking system to an Islamic banking system in the countries that have attempted to do so; primarily Iran and Pakistan. In particular, difficulties remain with PLS schemes where the large amount of work involved in determining the appropriate and achievable profit and loss sharing arrangement would be too much for many credit projects, both small and large. The same difficulties would also be encountered by MFIs wanting to finance small and micro projects following the PLS model.

However, there are good options for the financing of agriculture through other approaches. Two types of contracts, *bai muajjal* and *bai salam* offer good potential to finance the seasonal crops sector. Under *sharia* law, both types of contracts are viewed as trading rather than loan contracts.

Bai muajjal is a deferred payment for goods purchased from a trader. Under *sharia* law, two price tags are allowed: a cash price and a (higher) deferred-payment price. In Afghanistan, this practice is widely used by agricultural input suppliers. For instance, a bag of fertilizer paid for in cash will cost 600 Afs, while purchase on credit (payment after harvest) may cost 650 Afs.

---

[4] An informative article by A.L.M. Abdul Gafoor on the implementation and interpretation of *Sharia* banking, and other transactions by various religious experts and religious courts can be found at http://www.islamicbanking.nl/chap4.html

[5] See http://siteresources.worldbank.org/EXTISLAMF/Resources/ISLAMICFINANCIALProducts.pdf for a comprehensive listing of various Islamic financial products

> *Bai salam* is not the same as buying a crop which is still in the field. A *bai salam* contract specifies the quantity of a crop (by weight), the quality (for wheat–grade A, B or C), and a date and place of delivery.
>
> The buyer is not involved in the process of bringing the crop to harvest or in harvesting the crop, and does not take any risk of crop loss.

At least one development project in Afghanistan, with the International Fertilizer Development Center (IFDC), has used this system with input suppliers to improve and increase the flow of input credit to farmers.

The *bai salam* contract is the opposite of *bai muajjal.* It is, in effect, a futures contract under which a supplier is prepaid for goods which will be delivered later; whereby the buyer shares the risk of a price decline with the farmer. *Bai salam* in Afghanistan is best known for being used in opium poppy production and the illicit opium trade—opium buyers prepay for delivery of raw opium after harvest. Outside the opium trade, *bai salam* seems to be little used, and does not appear to have been used in development projects (see box).

A proposal for *bai salam*

This is an outline of a pilot proposal for a *bai salam* contract approach to providing seasonal credit for growing wheat and, possibly, potatoes. Under this system, the buyers of the wheat would be one or two large, commercial wheat mills; such as those in Herat and Mazar-i-Sharif, although a number of other mills exist. The sellers would be local wheat farmers.

Financing would be arranged for the wheat mills on the same terms that MFIs currently receive funds from MISFA (eight percent per annum). The mill would then use these funds to advance payments to farmers for the purchase of inputs at the beginning and during the wheat growing season. The farmers would then deliver an agreed quantity of wheat to the mills after the harvest. An example is presented in Annex A.

This proposal addresses the two deficiencies of the currently used MFI methodologies.

- *Bai salam* provides finance when finance is needed. The system provides cash when farmers need to purchase inputs and repayment is made in the form of wheat, after the harvest when wheat is available for repayment of the loan. The result is a 100% match with the cash flow requirement of the wheat crop.
- *Bai salam* is fully *sharia* compliant. Under *sharia,* it is not viewed as a loan contract but rather as a trade contract. As mentioned earlier, *bai salam* is in effect a prepaid futures contract.

Bai salam has benefits for both the seller (the farmer) and the buyer (the mill).

The seller (farmer):

- has access to finance when it is needed. This can be at the beginning of the season to sow the crop, or later to fertilize it, or just before harvest to feed the family.
- has a guaranteed market for the quantity of the produce that he has pre-sold.
- receives a guaranteed price for the quantity of produce that he has pre-sold.

The buyer (mill):

- can purchase at a price which is lower than the expected price at harvest time.
- is assured of a certain supply of produce for which he will not have to compete in the market place.

Finance (for wheat) is usually needed three times—at the time of sowing, later for fertilizing and finally during harvest. Therefore the contract would be structured to cover three purchases, each purchase being the equivalent of one disbursement.

The contracted price is a key element in the contract and, under the pilot scheme, would have to be negotiated between the mill and the farmers with the help of the finance institution providing the funds to the participating mills. The difference between the contracted price and the expected market price at harvest represents two items:

1. the interest lost to the buyer over the period of the contract, and
2. a compensation for certain risks. For example, the actual market price may be lower than the expected price, or the crop may fail and the buyer may not receive the full quantity of produce paid for.

Often with this type of arrangement in the informal sector, the contracted price may turn out to be unrealistically low, especially if there is an asymmetrical relationship between seller and buyer. This can occur in cases where, sometime during the growing season, the farmer is forced to sell part of his crop still in the field to meet urgent or unexpected expenses. In such cases the buyer can take advantage of a needy farmer.

However, in the proposed formal scheme the farmer will not be at a disadvantage, because the buying price at any moment during the season will be determined by those who lend the funds to the wheat mill.

The proposed system will therefore ensure a fairly discounted price by imposing the price on buyers and seller, every time a purchase (disbursement) is made. This is possible because of the formal nature of the arrangement and because of the low-cost finance and technical assistance, provided by the participating MFI.

Comparison of *bai salam* and *bai muajjal*

If *bai muajjal* is already being tested and used in Afghanistan (by IFDC) then why does *bai salam* need to be initiated? There are several reasons why *bai salam* should have very good potential in Afghanistan, perhaps better than other forms of agricultural *sharia* finance.

Firstly, *bai salam* for wheat could potentially reach large numbers of farmers because so many farmers in Afghanistan grow wheat. Beyond that, *bai salam* does not have one of the limitations of input finance through *bai muajjal*: by its very nature, input finance only finances inputs. The cash received through *bai salam* can be used more flexibly for other productive or consumptive purposes. For example it can, in addition to financing inputs, help to finance food and other basic household consumption items before the harvest.

Bai salam has another important advantage—the potential to cut out one layer of intermediaries. This is possible because the *bai salam* scheme would work with a relatively small number of large flour mills as outlets instead of a relatively large number of small input dealers (see Figure 2).

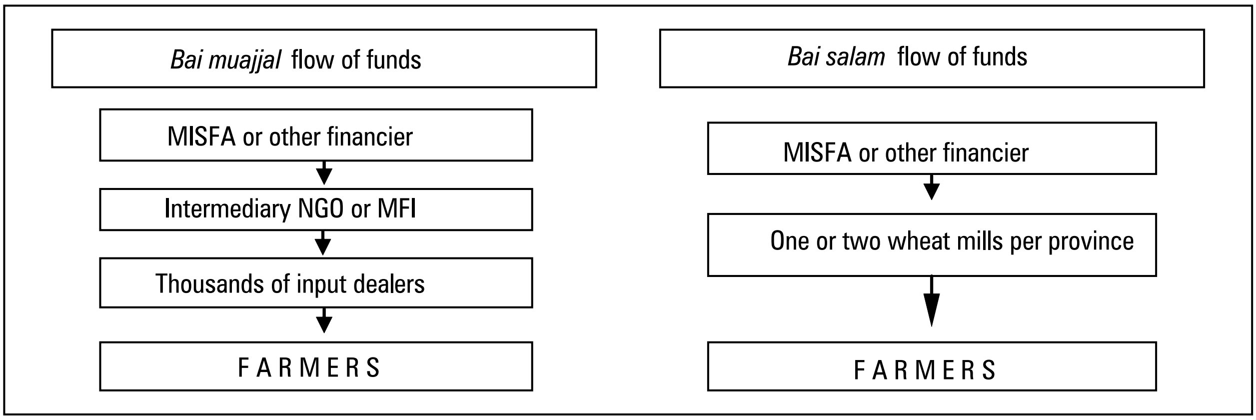

Figure 2. *Comparison of funding flow*

Bai salam will allow MISFA (or other wholesale lenders) to lend directly to the flour mills, without involving intermediary MFIs or NGOs. In other words, the flour mills would be at par with the MFIs to whom MISFA is currently lending because of the large scale on which they operate.

The approach of implementing loans to a few large flour mills, instead of to large numbers of small input suppliers, will also substantially reduce the capacity building task because of the economies of scale provided by the automation of the *bai salam* operation. Input dealers traditionally grant *bai muajjal* to only 100 or 200 farmers. This is because a larger number of creditors become unmanageable without modern data management tools such as computers and appropriate software.

Providing *bai salam* through flour mills would be much simpler and less expensive because only a limited number of flour mills need to be provided with software and training, while the mills would be providing the computer hardware themselves.[6]

Annex A: Example of *bai salam* (for wheat)

A *bai salam* contract for wheat would comprise the following steps:

1. The buyer (financier) pre-pays the farmer (seller) for his wheat, for example in March. The farmer receives cash in advance.
2. The farmer buys inputs for the cash received, and starts crop cultivation.
3. During the growing season, the farmer may need more cash, for which he makes a second, and third, sale of wheat. Each sale has its own price per kilogram.
4. The buyer receives the agreed kilograms of wheat after the harvest.

In cash terms, the example could look like this:

1. The farmer pre-sells one ton of wheat, grade B, for 9.00 Afs/kg in February 2007.
2. The farmer receives 9,000 Afs in February 2007.
3. The buyer receives 1,000 kg (one ton) of wheat, grade B in August 2007.
4. The market price for wheat in August may be 10.00 Afs/kg. Thus the buyer has saved 1,000 Afs.
5. The buyer would have incurred a loss if the price of wheat had dropped to less than 9.00 Afs/kg in August.

[6] The proposed software could be a version of the FAO-GTZ MicroBanking System, customized for *bai salam* or other appropriate software already in use in Afghanistan.