

# Salam Based Financing for Farm/ Crop Production Purposes

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## PREAMBLE

Generally, the farmers, particularly the small farmers need funds to finance cropping/harvesting activities like purchase of seeds, fertilizers, pesticides, diesel, labor etc. Presently, he/she either takes loans from conventional system and/or relies heavily on artees (آڑھنی) to meet his/her financing needs. No Islamic financing product is so far available to the farmers to meet their financing needs in Shariah compliant manner. This inhibits access of faith sensitive farmers to the financial/banking system. Cognizant of this limitation of the conventional banking system, a model product for meeting production finance (working capital) needs of the farming community has been developed.

## 1. PRODUCT

The product based on 'Salam' i.e. sale of agri produce against full payment in advance but deferred delivery on a specified future date, gives necessary flexibility to the farmer to use the funds to meet farming inputs requirements.

### 1.1. Single and multiple Salam

The farmers at their discretion may enter into single or multiple salam transactions based on their specific funding needs.

Under single salam the total funds needed by the farmer will be disbursed/credited to the farmer's account in lump sum.

Whereas, under the multiple salam transactions the funds would be disbursed in tranches as and when needed by the farmer by executing various/multiple salam. However, the farmer would have the option to choose the single or multiple Salam depending upon his/her convenience and preference.

### 1.2. Eligibility Criteria

All farmers/tenants/growers involved in raising crops are eligible to get financing from Islamic Banking Institutions (IBIs) under the scheme (Salam).

### 1.3. Assessment of financing needs & expected production

An objective assessment of farmers financing need is critically important for effectiveness of the facility for the farmer as well as quality of the IBIs' asset portfolio. The farmer normally needs financing for purchasing agricultural inputs like seed, fertilizer, pesticides, diesel for tractor, payment of water charges, labor etc. The IBIs should take into account all these genuine needs of the farmer(s) while assessing the financing needs. The indicative per acre financing limits prescribed by AC&MFD of SBP can also be used as one of the references for computing the farmer's financing needs(See Appendix-I)

Further the area to be cultivated and the expected production level should also be used as important parameters for assessing the financing needs and the maximum amount that can be given to the farmer.

To assess the expected production level of the commodity to be produced by the farmer, average per acre yields of the commodity in the region could be used.

#### 1.4. Maximum financing limits

The maximum financing to be extended to the farmer could be 1-3 years average market value of the produce being purchased under salam. Preferably, the quantity of the commodity to be purchased under salam may not exceed 75% of expected production.

## 2. PROCESSING OF APPLICATION

### 2.1. Process Flow/Procedure

- The farmers interested in multiple salam transactions will execute a Master Salam Agreement with the IBI to sell various specified commodities to the IBI on the basis of a memorandum of understanding (MOU) which will prescribe the framework for individual Salam contract.
- On the basis of MOU or Master Salam agreement, various individual Salam contracts/agreements are executed between IBI and farmer.
- The agreement describes complete specifications of the commodity (name, brand/type, quality etc), sale price and date and place of delivery.
- Upon execution of the salam contract, IBI pays the full sale price to client in advance by crediting the same in the farmer's account.
- The client/farmer may now utilize the funds at his/her discretion to finance different farm, non-farm activities.
- At maturity, client delivers the commodities as per agreement.
- The IBI would make appropriate arrangement for sale of the purchased commodity to a third party either directly or through some agency arrangement.

### 2.2. Security/Collateral

IBIs may secure their financing/investments by accepting security and collateral as per their financing policies which may include the following: -

- Charge on agricultural land through passbook system.
- Mortgage of rural, urban or commercial property.
- Pledge, Hypothecation/mortgage of assets e.g. processing, grading and packaging machinery, generator & refrigerators, etc.
- Lien on deposit with IBI OR on any liquid security (Gold, jewelry etc) up to the extent of the financing amount.

- IBI guarantee and/or;
- Individual/Group Guarantee/Cross Corporate Guarantee.
- Any other collateral /security acceptable to IBI.

### 3. PRODUCT PARAMETERS

#### 3.1. Pricing

The IBI will purchase the commodity (ies) from the farmer under Salam at a discounted price to be determined preferably by discounting the 1-3 year(s) average market price of the commodity (ies) by bench mark financing rate for agri finance.

#### 3.2. Hedging

As the IBI will be having an open position on the commodity (ies) being purchased under salam; it may enter into an agreement/sign MOUs with the party (ies), other than financed farmer/cultivator, for sale of the commodity (ies) at a specified price for delivering on a specific future date. This hedging shall however, be to cover the genuine open position caused due to various salam contracts executed by the IBI. Further the IBI may also sign MoUs etc with the prospective buyers of the agri produce including but not limited to provincial governments, food processing industries, floor/rice mills, sugar mills, agricultural marketing companies, local and international traders for sale of commodity This Agreement /MOU shall be exclusively independent from original Salam contract/agreement.

#### 3.3. .Tenure/Maturity

Salam financing may be allowed as per cropping cycle (as mentioned in Salam contract), however, the financing is usually provided for a period of 6 to 8 months, except for sugarcane crop, which can go up to 18 months.

## 4. DOCUMENTATION

### 4.1. Takaful/Insurance

IBIs should secure their financing for crop production through crop takaful/insurance to safeguard the interest of the bank and the customer from risks of losses due to natural calamities. It is advisable that banks should sensitize and educate their customers about the importance of having a takaful/insurance cover in this regard.

### 4.2. Documentation

Following documents should be signed; however, banks can secure its financing by obtaining any additional documents as per their financing policies and SBP regulations/guidelines. Completion of documentation formalities shall be the responsibility of the bank.

- Master Salam Agreement (MOU)
- Salam Agreement (for each separate transaction, in case of multiple salam contracts)
- All related charge documents
- Offer for sale of Goods
- Notice of Delivery /Receipt of Goods
- Agency Agreement (wherever required)
- Any other as required under Sanction Advice



## 5. Appendices

### 5.1. Appendix 1

#### **Normal Sowing and Harvesting Times of Important Crops in Different Provinces**

Crops	Normal Time of Sowing				Normal Time of Harvesting			
	Punjab	Sindh	KP	Balochistan	Punjab	Sindh	KP	Balochistan
Wheat	Oct/Nov	Sep/Nov	Oct/Nov.	Sep/Nov	May/June	Apr/June	May/June	Apr/June
Cotton	May/June	Apr/June	April/May	-	Oct /Dec	Sep/Dec	Oct /Dec	-
Rice	June/July	June/July	June.	June/July	Oct/Nov	Sep/Nov	Oct	Oct
Sugar-Cane	Feb/Mar	Feb/Mar & Sep/Oct	Mar & Sep/Oct	Feb/Mar	Nov/Mar	Oct/Apr	Nov/Mar	Nov
Tobacco	Jan/Mar	Sep	Nov/Dec & Mar	May	June	Oct/Nov	May/June & Sep/Oct	Oct /Dec

## 5.2. Appendix 2

### Indicative Financing Limits per Acre

S. No.	Major Crops	Limit per Acre (Rs)
1	Rice	19,000
2	Wheat	16,000
3	Cotton	21,000
4	Sugarcane	30,000
S. No.	Minor Crops	Limit per Acre (Rs)
1	Sugar Beet	17,000
2	Ginger	26,000
3	Potato	36,000
4	Turmeric	25,000
6	Maize	20,000
7	Onion	18,000
8	Ladyfinger	19,000
9	Peas (Mutter)	19,000
10	Tomato	19,000
11	Chilly	18,000
12	Other Vegetable	18,000
13	Garlic	16,000
14	Sorghum (Jawar)	11,000
15	Fodder Crops	10,000
16	Rapeseed and Mustard	11,000
17	Soybean	12,000
18	Sunflower	15,000
19	Canola	13,000
20	Coarse Grain (Others)	12,000
21	Millet (Bajra)	11,000
22	Gram	12,000
23	Moong	11,000
24	Masoor	11,000

S. No.	Major Crops	Limit per Acre (Rs)
25	Groundnut	14,000
26	Other Crops	16,000
27	Melon	16,000
28	Water Melon	16,000
29	Muskmelon	16,000
30	Nurseries for Flower/Plants	28,000
31	Flowers	26,000

S. No.	Matured Orchards	Limit per Acre (Rs)
1	Mango	37,000
2	Apple	37,000
3	Almond	32,000
4	Apricots	31,000
5	Banana	35,000
6	Cherry	33,000
7	Citrus	33,000
8	Dates	31,000
9	Grape	32,000
10	Litchi	32,000
11	Peach	32,000
12	Plum Pomegranate	33,000
13	Cheeko	27,000
14	Coconut	21,000
15	Guava	24,000
16	Loquat	24,000
17	Palm	22,000
18	Pear	24,000
19	Jujuba	23,000

Issued Vide ACD Circular No. 5/2008

## 6. MODEL PRODUCT

The methodology and process flow hereunder has been designed for better understanding of Salam transaction for crop production. It has been explained with an example of Wheat crop. Farmer X has to cultivate/ grow wheat on 10 acres of his/her land holding. As the farmer, on average, needs Rs. 16,000 – 20,000 per acre to procure various agri-inputs for cultivating the wheat crop; he/she would thus need Rs. 160,000-200,000 to procure agri-inputs for cultivating wheat on a farm of 10 acres. While the overall financing need is estimated based on average cost per acre, the bank shall also see the average per acre yield of the commodity to estimate the total production of the commodity and the quantity to be purchased under Salam. Preferably the quantity to be purchased should not be more than 50-75% of the total expected crop production.

### 6.1. Option 1

#### Single Salam:-

The wheat farmer having 10 acres of land approaches IBI for sale of wheat under Salam.

1. Cultivated Area	:	10 acres
2. Average estimated production cost per acre:	:	Rs.16, 000 per acre
3. Total estimated cost for 10 Acers	:	Rs.160, 000
4. Average Yield per acre	:	25 mounds <sup>1</sup> (1 mound=40Kg)
Total expected production	:	250 mounds
5. The quantity eligible for sale under Salam	:	50-75% of expected output
6. Average Market price of wheat per 40Kg	:	Rs. 1,000
7. Discount Rate to be used to determine the discounted price	:	KIBOR + X%
8. Discounted price per 40 Kg	:	Rs. 900 <sup>2</sup> (Rs. 22.50 per Kg)
9. The total value of quantity of wheat eligible for sale under salam	:	Rs. 112,500 (50% of expected output)
10. Financing amount	:	Rs. 160,000 or the total value of wheat eligible for sale under Salam whichever is less (Lesser of No.3 and 9). <sup>3</sup>
11. Tenure	:	160 days
12. Disbursement date	:	November 01, 2010 <sup>4</sup>
13. Maturity date	:	April 10, 2011

<sup>1</sup> Average yield per acre will vary from area to area.

<sup>2</sup> To be determined using normal Avg. Financing rate upto (KIBOR+X %)

<sup>3</sup> In case the total value of wheat (commodity) eligible for sale under Salam is greater than the total expected cost of production (Rs.160,000 for this example) the quantity to be purchased under Salam shall be =160,000/Discount price.

<sup>4</sup> The dates used in this model product are arbitrary

**PROCESS FLOW:**

Under Salam Agreement, the IBI agrees to Purchase 125 mounds of wheat at Rs. 22.50/Kg (Rs.900 per 40 Kg) against advance payment of Rs. 112,500/-in full for delivery by April 10, 2011.

**Security/Collateral:**

The bank may take necessary guarantees/security including charge on farm land through existing passbook system to have comfort that the farmer shall deliver the commodity by the due date.

**Agency agreement:**

The bank may enter into an agency agreement with the farmer whereby the farmer would sell the produce on behalf of the bank as and when advised. If needed and depending upon the policy and practices of the IBI, the agency arrangement can also be made with third persons/institutions to procure and sell the produce on behalf of IBI.

**Disbursement/payment of funds:**

The funds equivalent to the value of commodity purchased under Salam shall be credited in the farmer's account for use at his/her discretion. The funds shall, however, be disbursed after execution of all agreements and creation of charges etc as per bank's policy.

On Due Date(s) the farmer shall deliver the goods to the bank with Notice of Delivery. The possession of the goods by the Bank may be physical or constructive. A Bank representative will accept the delivery on Goods Receiving Letter after physical inspection of the goods at the site. The Salam Agreement is completed and the risk of asset is transferred from the customer to the Bank.

Alternatively the IBI may also advise the farmer to deliver the produce to a specified person at a specified location and submit the deposit receipt, etc to the IBI to settle his/her account/liability.

In case where agency arrangement is made with the farmer, on the delivery date i.e. April 10, 2011, a "Letter of Agency" (appendix of Master Agency Agreement) will be issued by Islamic Bank to farmer X, under which Islamic Bank would authorize the farmer X to sell the Wheat in the market at market price or such minimum price as may be given by the bank based on its product pricing policy.

One of the approaches to determine the minimum sale price may be Discount price +  $180/365 * (\text{bench mark rate} + Y)$ .

Farmer X will provide reliable evidence of the sale of Wheat e.g. invoices. Till April 30, 2011, farmer X deposits sale proceeds with Islamic Bank.

On April 30, 2011, Islamic Bank will settle its Salam Financing against the deposited sale proceeds to close the transaction.

## 6.2. Option 2

### Multiple Salam:-

The wheat farmer having 10 acres of land approaches IBI for Sale of wheat under multiple salam.

Cultivated Area	:	10 acres
Average estimated production cost per acre:		16,000 per acre
Tenure	:	160 days
Average Market price of wheat per 40Kg	:	Rs. 1000
Discounted price per 40 Kg	:	Rs. 900
Total quantity of wheat to be delivered	:	125 mounds (1mound=40Kg)

#	Stage	Disbursement Date	Purpose	Amount (Rs.)	Qty of Wheat to be Delivered (Kg)	Date of Delivery
1	Preparatory	01-11-2010	Land preparation/ water, etc	40,500	1,800	10-04-2011
2	Sowing	20-11-2010	Seed/ labor/ fertilizer/ water, etc	27,000	1,200	10-04-2011
3	Growing/ Plant Development	20-12-2010	Fertilizer/ water, etc	20,250	900	10-04-2011
4	Dough Stage/ Grain Development	01-02-2011	Pesticide/Fer tilizer/ water, etc	15,750	700	10-04-2011
5	Maturity	15-03-2011	Harvesting	9,000	400	10-04-2011
	<b>Total</b>			<b>112,500</b>	<b>5,000</b>	

**PROCESS FLOW:**

Under Multiple Salam Agreement, the IBI agrees to Purchase 125 mounds of wheat at Rs. 22.50/Kg (Rs. 900 per 40 Kg) against advance payments as per the table of total amount Rs. 112,500/- for delivery of wheat as per the dates mentioned in table.

**Security/Collateral:**

The bank may take necessary guarantees/security including charge on farm land through existing passbook system to have comfort that the farmer shall deliver the commodity by the due date.

**Agency agreement:**

The bank may enter into an agency agreement with the farmer whereby the farmer would sell the produce on behalf of the bank as and when advised.

**Disbursement/payment of funds:**

The funds equivalent to the value of commodity purchased under every salam shall be credited in the farmer's account for use at his/her discretion. The funds shall, however, be disbursed after execution of all agreements and creation of charges etc as per bank's policy.

On Due Date(s) the farmer shall deliver the goods to the bank with Notice of Delivery. The possession of the goods by the Bank may be physical or constructive. A Bank representative will accept the delivery on Goods Receiving Letter after physical inspection of the goods at the site. The Salam Agreement is completed and the risk of asset is transferred from the customer to the Bank.

In case where agency arrangement is made with the farmer, on the delivery date i.e. April 10, 2011, a "Letter of Agency" (appendix of Master Agency Agreement) will be issued by Islamic Bank to farmer X, under which Islamic Bank would authorize the farmer X to sell the Wheat in the market at market price or such minimum price as may be given by the bank based on its product pricing policy.

One of the approaches to determine the minimum sale price may be Discount price +  $180/365 * (\text{bench mark rate} + Y)$ .

Farmer X will provide reliable evidence of the sale of Wheat e.g. invoices.

Till April 30, 2011, farmer X deposits sale proceeds with Islamic Bank.

On April 30, 2011, Islamic Bank will settle its Salam Financing against the deposited sale proceeds to close the transactions.

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