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POTENTIAL APPLICATION OF BAY' AS-SALĀM CONTRACT IN ISLAMIC BANKING IN INDONESIA

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ABSTRACT

Islamic banking in Indonesia has developed and grown tremendously in recent times. This is proved with the launch of various products, however they have not yet applied a form of Islamic forward contract bay' as-salam as a mode of financing due to it being more susceptible to risks than the other Islamic commercial contracts used by Islamic banks in Indonesia. This research attempts to analyze some factors as to why bay' as-salam does not seem attractive to the Islamic banks to implement, then to explore the theoretical possibility of its future application as well as to propose a working model. Due attention will be paid to comparision between bay' as-salām and the future of contract applications in the Islamic finance industry. The methodology approached is focused on library research and conducting interviews with Islamic bank officers. The study proposes a bay' as-salam model based on wakālah contract to be applied in Islamic banks in Indonesia.

KEYWORDS: *bay' as-salam*, Islamic financing, *wakālah* contract, Islamic banking, risk factors, Indonesia.

1. INTRODUCTION

The Islamic financial industry globally has shown fairly rapid development in recent times. Based on data from the IFSB Financial Stability Report in 2016, the assets of the world's Sharī'ah-compliant financial industry have grown from about USD150 billion in the 1990s to about USD2 trillion by the end of 2015 and are projected to reach $ 6.5 trillion in the year 2020. Indonesia, the most populous Muslim country in the world, has huge potential for Islamic finance (87.19% of Indonesia's population of 237 million are Muslims). Although still relatively small on a national scale, the industrial development in Indonesia's Sharī'ah-compliant financial sector has shown significant development in the global arena.

The Indonesian Islamic financial assets (excluding Islamic stocks) have reached IDR889.28 trillion or approximately US$66.18 billion, and the available data shows that the Islamic banking sector has 41.04% or IDR365.65 trillion or US$27.21 billion (GIFR, 2017). This rapid growth of Islamic banking should be accompanied by the development of products and various contracts in accordance with Islamic principles. This development is expected to meet the needs of customer transactions. One of the important issues faced by Islamic banking is the problem of financing products that are still dominated by *Murābaḥah, Mushārakah and Mudārabah,* while another contract such as *bay' as-salam* that could be implemented is neglected.

With the addition of the term "Islamic" to banking, Islamic banking is expected to be unique with the integration of greater moral and Islamic values compared to other conventional institutions. The objective is not solely to maximize profit but also to achieve socio-economic development and the alleviation of poverty.

Since *bay' as-salam* is rarely implemented in Islamic banking in Indonesia, it is critical to examine the risk-taking behavior of contracting parties. Several factors may lead to banks being reluctant to employ *bay' as-salam*. Perhaps it is a lack of understanding on the part of banking practitioners with regards to the application of the contract, as financial literacy does not reach every level within the community, besides several risks inherent in the contract itself. Therefore, regarding the aim of Islamic finance, Az-Zuḥailī, (1997) mentioned that Islamic Financial Institutions (IFIs) are not profit making, but work towards the endorsement of social goals of socio-economic development and the alleviation of poverty (Salihu et al., 2011). The implementation of *bay' as-salam* contract is believed to expand the role of Islamic banking, therefore, this study aims to identify factors obstructing the practice of *bay' as-salam* in Islamic banks in Indonesia. Following this, strategies for designing the *bay' as-salam* model will be proposed for the development of the Islamic banking industry. Once these factors are identified, the next step is to find solutions that make this mode of financing applicable to products, bankable and marketable, to be applied in the Islamic banking industry.

2. LITERATURE REVIEW

2.1 Overview of *Bay' As-salām*

Bay' as-salam can be defined as: A sales transaction in which the buyer will give the payment in advance for the goods that will be delivered by the seller at a future date specified in the contract. The Shāfi'īs and Hanbalīs defined it thus: A forward contract over described merchandise sold as a deferred liability on one party, in exchange for a price that is received during the contract session. The opinion of Mālikīs is: It is a sale in which the capital sum (price) is paid in advance, and the object of sale is deferred to a specified term" (Az-Zuḥailī, 1997).

If the price is a tangible (e.g., currency) it must also be delivered during the contract session. This is to avoid the selling debt and such deferment would fall under the prohibition of the Messenger of Allāh ﷺ of "trading one deferred item for another". This condition is agreed upon by the Hanafīs, Shāfi'īs, and Hanbalīs. However, Imām Mālik stipulated that deferment of receiving the price is permissible for three days or less, even if this deferment is stipulated as a condition of the contract.

A hadīth narrated by Al-Bukhārī and Muslim clarifies that the Messenger of Allāh ﷺ came to Madīnah and found its inhabitants entering *as-salam* contracts (with the price paid in advance) over fruit produce for a period of one, two or threeyears in advance. He ﷺ said: *"Whosoever makes buying and selling by way of salaf (as-salam), he should buy and sell with a specified weight and measure up to the time limit*[1]*."* However, there are four elements which must be fulfilled, namely:

1. buyer *(al musllam 'ilayh)*
2. seller *(al musllem)*
3. transaction objects/goods *(musllam fīhi)*
4. agreement of offer and acceptance *(sīghat ījāb wa qabūl)* (Az-Zuḥailī, 1997).

Furthermore, it is said: "Whosoever engages in *as-salam* contract, let him specify a volume or weight for the object of sale, and a definitive term of deferment." Thus, jurists of all schools of Islamic jurisprudence considered the forward sale of tangible commodities (measured by weight, volume, length/size, or number of homogeneous units), with full prepayment of the price, to be a valid contract (El-Gamal, 2006). It is well known that there is a consensus among all scholars

[1] Al-Bukhārī, Hadith (no.2239) and Muslim (no.4094)

regarding the permissibility of *bay' as-salam* to help needy farmers with their agricultural produce and to feed their families up until the time of harvest ('Uthmānī, 2002; ISRA, 2011).

According to Muneeza et al. (2011) the *as-salam* contract conditions can be classified into:

1. The buyer should fully pay the price of goods in cash at the time of the contract to avoid sale of debt against debt since it is not allowed in Islam.
2. Everything must be clearly stated in the contract, this includes the quality and quantity of the products. This is aimed at avoiding the resultant uncertainty (*gharar*).
3. The time and place of delivery must be agreed upon by both parties, but if there is any change in these it can be revised again by mutual agreement.
4. Only commodities which can be measured precisely by their quality and quantity can be involved in *as-salam* contract. For example, precious stones cannot be sold on the basis of *bay' as-salam* because usually every piece is different from the other either in its quality or in its size or weight and their exact specification is not generally possible.
5. The subject of *as-salam* contract must be available at the time of delivery.
6. In terms of the subject of *as-salam* that must be delivered on the spot such as gold, silver, wheat and others items of interest (*ribawi*) cannot be implemented in *as-salam* contract.

According to the Sharī'ah point of view, the selling or buying of non-existent objects is forbidden due to uncertainty (*gharar*) but there are some exceptions such as *as-salam* and *al-istiṣnā'* which are permitted in Islam. So, forward contract is acceptable according to the Sharī'ah principles if they adhere to the contract of *as-salam* and *al-istiṣnā'*.

2.2 Factors hindering the implementation of *bay' as-salam* sale in Islamic banks

According to research conducted by Ayub (2013) there are certain risks attached to the *bay' as-salam* such as counterparty and delivery risk, price risk, marketing risk, asset-holding risk and early termination chances. However, he argued that these risks can be solved by improving the management of assets. Putri and Dewi (2011) have pointed to three problems in conjunction with the implementation of *bay' as-salam* in Indonesia by BPRS or Islamic Rural Bank which are: unavailability of sufficient business models, insufficient risk management and the perception of bankers that this contract is unprofitable. The result is still not ideally appropriated with Islamic teachings. Nonetheless they suggested performing some adjustment by referring to the fatwa concerning this matter.

Furthermore, Kaleem and Wajid (2009), explored the possibility of *as-salam* contract in the agriculture sector of Pakistan. They concluded that this financing scheme is fully viable in assisting poor farmers in Pakistan as it is acceptable with regard to the operation of the modern banking system. Even so, the application of the *as-salam* contract should be implemented wisely to avoid large scale default. They recommended to the banks that the proposed *bay' as-salam* scheme should carefully select the farmers; only eligible farmers who have a good reputation can be accepted to make the contract, and banks must control the contract effectively to reduce operational costs, and lastly to appoint middlemen as partners or agents.

Besides that, Muneeza et al. (2011) in their exploratory study stated that *as-salam* is a risky contract compared to other commercial contracts. However, an appropriate *as-salam* model could assist poor farmers in the country, which will automatically promote the development of the economy in Indonesia. Therefore, the *bay‘ as-salam* condition gives mutual benefit among the parties involved, where the seller gets some money in advance for his insufficient budget for production and the buyer can obtain a special price which is usually at a lower rate than the market value (Kaleem & Ahmad, 2016). Looking at the previous studies mentioned above, *bay' as-salām* contract is one of the Islamic financing instruments that brings a lot of risk, since selling the product faces market uncertainty which affects the price volatility thus making this contract relatively risky.

3. METHODOLOGY

A qualitative research methodology based on two approaches was employed to meet the objectives of this study. A content review analysis based on past literature was adopted for the sake of identifying common factors preventing the application of *bay‘ as-salam* in the Islamic banking industry in general and in Indonesia in particular. Based upon this, several issues were highlighted then posed to experts working in the banking industry. Beneficiaries represented by Indonesian farmers were interviewed as well in order to discover obstacles confronting them if this specified contract was applied.

4. DISCUSSION

4.1 Inhibiting Factors

Previous studies indicated a number of inhibiting factors confronting the application of *bay‘ as-salam* in the Indonesian Islamic banking industy. Such a study was conducted by Ascarya and Yumanita (2006), in which they examined several factors caused by the lack of profit and sharing (PLS) in Indonesia's Islamic banks using the Analytic Network Process (ANP) methodology. They placed these into four aspects, namely: Islamic bank internalities, customers, regulations, and the Government. It was taken into consideration that some of them may occur in the area of *bay‘*

as-salam contract which is not implemented yet by Islamic banks in Indonesia (Ascarya, 2009). They are as follows:

4.1.1 Avoiding risks

The quality and quantity of the agricultural sector is highly dependent on the season and weather as well as fluctuating prices of agricultural commodities, hence this sector is considered risky for banks. Therefore, due to these reasons banks do not engage in the *bay' as-salam* contract.

4.1.2 Regulations

Regulations have the greatest contribution in the development of Islamic banking in Indonesia, thus the implementation of *bay' as-salam* needs a special policy to support it.

4.1.3 Low comfort level

Contracts in Islamic banks are still dominated by *murābaḥah, mushārakah,* etc. and as far as banks are concerned, they are more comfortable with these contracts. Thus, in financing to the agriculture sector, banks perceived it was not necessary to utilize *bay' as-salam* as other contracts were already accommodated by banking operations. Therefore, they did not establish *bay' as-salām* as one of the tools of Islamic financing.

Banks (including Islamic banks) will always naturally play safely in managing funds to the counterparty because *murābaḥah* is a system that gives more returns, it is easier to apply, and is less risky. The alternative is *bay' as-salam*, which is not easily carried out into practice by Islamic banks.

4.1.4 Profit/business oriented

It is difficult to say that Islamic banks give more space to social benefit-oriented transactions; maximizing profits will always be a priority. Thus, banks pay the greatest attention to the business sector which is more profitable and provides fixed results. Therefore, the uncertainty of *as-salam* financing in the agriculture sector will be a major factor for banks to exercise prudence in involving this contract.

4.1.5 Limited channeling

Most farmers live in villages or rural areas which are not the areas where most banks are located, since they are concentrated in urban areas. It is thus difficult to obtain funds for farmers in the banking environment. Transportation costs and the costs of administrative or legal documents incurred by the farmers could make them prefer the option of alternative financing which appears more straightforward, such as money lenders who impose interest.

4.1.6 Long term financing

As-salam financing in the agriculture sector requires a long period of harvest. This fact obviously poses a risk for banks, since banks are business institutions that are also obliged to submit a return for the results on a regular basis over the term of the existing deposits. For instance, bank deposit types that usually have a one-month period must refund the original amount plus profit sharing to their customers every month. Therefore, banks should be able to generate returns in a short time, so the solution is to place the fund into a profitable transaction, for example into *murābaḥah*, which will give returns within a certain time. This is one of the factors affecting why banks are reluctant to get involved in *bay' as-salam* financing in matters of placing funds in long-term financing.

4.1.7 High cost

This mode of financing also requires high operating costs as the banks need to ensure returns by conducting a survey prior to making the contract, the cost of controlling and monitoring during the process, transportation or delivery costs and most importantly, recovering the cost if the harvest fails and so on.

4.1.8 The bankability of farmers

In the eyes of the banks, farmers are not bankable because small farmers do not have good working knowledge of accounting and reporting of agricultural activity. In addition, the legal aspect is also the reason that small farmers are not bankable which includes the inability of farmers to show business licenses as well as provide additional collateral which is held by the banks to cover the financing risk.

4.2 The Bank's Preference of *Bay' As-salam* and Justification

Despite the consensus among Muslim jurists on the permissibility of *bay' as-salam* and its potential as a mode of financing, none of the Islamic banks in Indonesia are currently applying it in their operations. Therefore, this section will seek to find out why Islamic banks are reluctant to implement *bay' as-salam* as a mode of financing for their customers. Furthermore, it will attempt to investigate the obstacles and challenges that are hindering its implementation by the Islamic banks in Indonesia.

4.2.1 Regulations

According to our interviewees the main impediment to the application of *bay' as-salam* as a mode of financing by Islamic banks in Indonesia are the regulations that restrain the Islamic banks from getting involved in direct trading. However, the application of *bay' as-salam* necessitates the involvement of the bank into direct trading where it buys a commodity from the farmer and then sells it with profit to commodity traders or manufacturers who use it as raw materials. Since the bank is not in need of the commodity, it has no other choice.

This confirms the finds of previous studies such as Ascarya (2009), which stressed the importance of proper regulations in the development of Islamic Finance. The Islamic banking system cannot flourish without appropriate rules and regulations in place. Therefore, it is vital to revise and amend the existing regulations in order to allow Islamic banks to provide financing through *bay' as-salam* for those in need of it to realize their potential and increase their welfare.

4.2.2 Counterparty Risk

Risk is one of the factors mentioned by our interviewees as a major challenge for the implementation of *bay' as-salam* by the Islamic banks in Indonesia. Counterparty risk refers to the possibility that one of the parties to the transaction could default (Bacha, 2017). *Bay' as-salam's* similarity to the forward contract makes it susceptible to the counterparty risk that is found in the forward contract. However, Bacha (1999) points out that counter party risk in the *as-salam* contract is one sided, since the buyer (bank) has to pay the price in full to the seller (farmer) at the time of affecting the sale. The seller (farmer) will not be exposed to the counterparty risk, because he has already received the payment in full at the signing of the contract which is one of the conditions of *bay' as-salam* as pointed out earlier.

Nevertheless, the buyer (bank) will still be exposed to the counterparty risk since there is a possibility that the seller (farmer) might fail to deliver the commodity as specified in the contract. Furthermore, there is the risk that he may not recover the money he paid when he was entering the contract. This makes *as-salam* even riskier for the buyer (bank) than the forward contract. Therefore, *bay' as-salam* is not appealing to Islamic banks which are often driven by the objective of maximizing profit and minimizing risk.

4.2.3 Commodity Price Risk

In addition to the counterparty risk, there is a commodity price risk involved in *bay' as-salam*. Our interviewees asserted that the bank will be exposed to losses if the price of the commodity falls at the time of delivery. Since the bank does not intend to hold possession of the commodity it will have to sell it at the prevalent price, thus incurring some losses. However, this could be resolved by resorting to parallel *as-salam* where the bank enters into another *as-salam* contract with a third party for the same commodity that it is going to acquire from the first contract, to be delivered at the same time or this risk can be mitigated through indulging in Takaful service for the crop.

Takaful would compensate the farmer financially in case of any damage to the crop (Ehsan & Shahzad, 2015).

4.2.4 High Cost

Another obstacle raised by our interviewees is the high cost of implementing *bay' as-salam*, where the bank would incur various costs through the process of the *as-salam* contract:

- Before entering into the *as-salam* contract the bank has to assess the creditworthiness and honesty of the farmer. This investigation requires resources which may be higher than the assessment of conventional customers who have a record of taking up loans or have a stable income.

- After the agreement with the farmer on the *as-salam* contract, the bank must find another party who is interested in buying the commodity upon its delivery from the farmer since the bank is not in need of the commodity. Thus, it will bear further costs in the process.

- However, if the bank does not find a buyer for the commodity upon its delivery from the farmer it will incur the cost of storage of the commodity which may in some cases be very high.

4.3 Comparison between *Bay' as-salam* and Forward contract

Forward contracts are basic financial risk management tools that could be used for hedging against price fluctuations and reducing risk. It is the closest derivative contract to *bay' as-salam;* there are striking similarities between the two contracts. Despite these similarities there are differences between the forward contracts and *bay' as-salam* as well. Hence this section seeks to explore the similarities and differences between the two contracts.

Bay' as-salam is considered the Islamic version of the forward contract. *Bay' as-salam* is defined as: "a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advanced price fully paid on the spot" (Usmānī, 2002, p.186). Whereas a forward contract is: "An agreement between two parties to deliver and make payment for a designated commodity or service at a designated future date" (Paul et al., 1976).

Both the contracts are agreements on the future delivery of a specified commodity on a specified future date. Furthermore, they are over-the-counter negotiated instruments; their prices, quantities and maturities are determined through a negotiation between the parties involved. However, there is one major difference between the two contracts. In *bay' as-salam*, the buyer has to pay the full price of the commodity to the seller upon entering into the contract of *as-salam*. Failing to do so would render the contract null and void. This condition is unanimously agreed upon by the Muslim jurists although Imām Mālik allows two to three days of concession (Paul et al., 1976).

On the other hand, the buyer in a forward contract is not required to pay the full amount at the time of affecting the sale. With the exception of prepaid forward which involves paying today to receive the asset in the future (McDonald, 2003, p. 120), the buyer has to pay the full price only upon delivery in standard forward contracts. This is the reason why the conventional forward contract is considered un-Islamic, since both the delivery of goods and payment is being made at a future date, hence violating one of the conditions of *bay' as-salam*. Furthermore, failing to uphold this condition makes the forward contract tantamount to sale of a debt against a debt, which was prohibited by the Prophet ﷺ.

In addition to this, *bay' as-salam* differs from forward contracts in that its underlying asset has to meet certain criteria. The Sharīʻah has put certain conditions on the underlying assets which are not necessary in forward contracts. For instance, *as-salam* cannot be affected with respect to things which have to be delivered on the spot, such as the exchange of gold for silver, as the Sharīʻah requires the simultaneous delivery of the two commodities. Failing to do so would be tantamount to usury (*ribā)*, whereas the underlying asset in forward contracts can be currency for currency (Ringgit for Dollars), gold for currency or any other financial asset. Therefore, the underlying assets in *bay' as-salam* are more restricted than forward contracts, making it less flexible.

5. CONCLUSION

The *bay' as-salam* contract in Islamic commercial law is of the important methods of investment in Islam because the aim of the contract is to finance farmers in a production level, and *as-salam* can play an important role in economic development. It encourages the demand for agricultural goods to be stabilized and at the same time grants benefits to the farmers. Currently, *as-salam* is not practiced as a mode of finance in Indonesia because of many reasons such as counter party risk, high cost, commodity price risk and regulation risk.

Therefore, to mitigate all these risks that banks might face if they implement the *as-salam* contract, these are the policy recommendations:

1. Banks should initially sign selected contracts under *bay' as-salam* as caution is needed in the presence of existing debts of the farmers due to a multi-pronged obligation to serve the debts. This to mitigate the counter party risk. In other words, banks should finance only potentially suitable farmers.

2. The reputation of the farmer should play a vital role in the whole finance decision. Guarantees of future delivery should be awarded to potential suitable farmers and the farmers should have to provide the guarantor a guarantee in the case of defaults.

3. Banks may appoint middlemen as their agents or partners. This arrangement can play two important roles: to reduce the operational risk to the bank in the case of default delivery, and to transfer the risk to a third party.

4. Quick and efficient decision making will be critical for the success of such a contract due to the farmers having a specific time frame to produce their commodities.

5. Continuous monitoring and information sharing with the middlemen in previous defaults can play an important role in building trust and cost-efficient working relationships.

6. Sale of substandard seeds, fertilizers and other inputs should be strictly curtailed, otherwise if the crop fails, banks will not even be able to recover their original investments until the next harvest.

7. The initial starting point from the Bank Central of Indonesia is essential. This is because when there are proper regulations and guidelines to follow, the Islamic Bank will have a greater comfort level as there is a guarantee from the regulator.

To support all these given recommendations, these are the proposed models for *as-salam* financing under Islamic banking. The first model where there is no third party or middle man involved in the process. The product innovated here is a hybrid of *as-salam* using a *wakālah* contract. These are the processes:

1. The bank opens and advertises to farmers to apply for *as-salam* assistance facility.
2. Farmers apply for the facility.
3. The bank chooses farmers by looking at their background information.
4. The bank enters into *as-salam* agreement with the farmer.
5. The bank pays the money in full.
6. The bank enters into an independent contract of agency with the farmer, appointing him as a bank agent to sell the products.
7. The farmer finds customers to sell the products and enters a promise with them.
8. The farmer delivers the product constructively to the bank and as an appointed agent of the bank, the farmer will immediately sell the products to the consumers. Owing to unforeseen calamites, if the farmer fails to produce the amount agreed, he should buy it from the market and supply it.

9. The farmer gives the sales money to the bank and bank pays a wage to the farmer for his work.

What happens in this scheme is that the bank will introduce a facility in which they will invite farmers who need assistance to produce agricultural products to apply for bank assistance. The bank would be the buyer of the products using *as-salam*. The farmers have to give details of the farm size and the products they intend to produce.

The amount, quality, and the date of delivery shall be specified in the documents. Two guarantors must also be stated in the documents who are willing to indemnify if anything goes wrong and at the same time the availability of the product which they intend to grow must also be specified. So, the bank would examine all the applications made by the farmers and will choose the most profitable products, and they will also look at the capability of producing such a product within the period specified. The guarantors would be checked, then the bank will choose the farmers to which it is ready to give *as-salam* assistance.

The following model is when the third party comes into the picture when an Islamic bank opens an independent subsidiary as their agent which deals with farmers on behalf of the bank. The bank provides direct finance to the farmers only against the recommendations of its subsidiary, and when the farmers furnish the required guarantees. On the hand, it is the responsibility of the subsidiary to provide technical advice, monitoring and collecting the crop from farmers. The subsidiary may also arrange crop inputs for the farmers. Once the crop is received, the subsidiary is responsible for selling it in the market and sharing the profit with the bank as per the agreement.

Farmers also mentioned some possible problems regarding the appointment of middlemen as agents, such as they will:

- Give less profits.
- Consider their own benefits.
- Take high service charges against the facility provided.
- Give preference to their own relatives.
- Delay payment.
- Offer smaller amounts in cash.
- Offer lesser rates for the crop than the market.

Although famers do not seem satisfied with a third party in the picture, but the banks are in agreement with this model as they want to transfer the risks to the third party.

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