

# Sharia Microfinance Institutions Financing Model for Strengthening Agricultural Sector

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**Abstract.** The agricultural sector is a sector that has a strategic role in economic development in Indonesia. However, the agricultural sector has several problems such as less secure of farmers' welfare, low access to capital and marketing of crops. The existence of farmers' groups and Sharia Microfinance Institutions (*LKMS*) has not been able to optimize the potential of the agricultural sector. The purpose of this study is to formulate a strengthening model from institutional aspects through local farmers' groups and capital strengthening through the inter mediation of Sharia Financial Institutions (*LKS*) through a linkage program. The model of institutional strengthening of farmers' groups and capital of *LKS* financing can be one of the foundations of national economic development. This study used a qualitative approach. Data were collected from the results of in-depth interviews, focus group discussions (FGD) and questionnaires. This study examines: (1) strengthening of farmers' group institutions; (2) development of the agricultural sector financing model through inter mediation between local *LKS* and *LKMS* and linkage programs between farmers' groups and *LKMS*

*Keywords:* institutions, farmers' groups, sharia financial institutions, linkage financing models

## 1. Introduction

Indonesia is a country known as an agricultural country. The reason is the majority of Indonesian population makes their livings in agricultural sector or farming. According to Central Bureau of Statistics (BPS), 29.683% or equivalent to 35,923,886 people aged 15 years and over are workers in agriculture [4]. Meanwhile, other employment sectors have fewer workers than in agriculture. In addition, agricultural sector has a large contribution to Indonesia's Gross Domestic Product (GDP). According to BPS, agricultural sector contributes 13.36% to Indonesia's GDP [5]. This condition illustrates that agricultural sector has great potential in developing the Indonesian economy.

However, further study shows it is undeniable that in general people who work as farmers live below the poverty line. BPS (2013), in the agriculture census, concluded that the majority of the poor (28.28 million people) in Indonesia are farmers (26.14 million). This phenomenon does not reflect great potential of the agricultural sector. The insignificant contribution of agricultural sector to the economy is caused by several problems. The most crucial problems in the Indonesian agricultural sector are institutional and trade system [16]. Institution is highly required in the production, processing and marketing processes of agricultural products.



Farming institution plays an important role in agricultural business; one of which is through farmers' groups. Farmers' groups is built based on common business, which aims to manage farming business on the basis of togetherness and business facilities fulfillment. However, farmers' groups often meets with obstacles, such as insufficient concepts and knowledge the farmers have about production and marketing result management, farmers are not fully engaged in agribusiness activities and the role of farmer institutional functions has not yet run optimally [10]. In general, institution is still built on a top-down approach, namely through a uniform blueprint but less exploration of the existing structure and local institutional networks. Therefore, institutional development is more focused on its structural aspects but lack of reinforcement on its cultural aspects [14].

Bank Indonesia as the central bank of the Republic of Indonesia regulates financial issues extensively. In order to improve banking intermediation function and expansion of financing, Bank Indonesia has established a joint cooperation program between Public Banking through Rural Banks with Microfinance Institutions to expand financing in the micro and small sectors, such as agriculture called the Linkage Program since 2002. Linkage Program in sharia finance is a form of cooperation among Sharia Commercial Banks with Sharia Microfinance Institutions (hereinafter referred to as LKMS) in the form of financing distribution in an effort to improve micro and small business activities, including the agricultural sector. Sharia Commercial Banks as parties having surplus of fund will get yield on financing while for the recipient the risk received will be minimized as an implication of risk sharing principles determined by sharia financial institutions.

## 2. Literature Review

### 2.1 Farmers' groups Institution

Institution can be defined as order which is well followed and upheld by community members, that provides protection and obstruction for individuals or community members [1]. Institution is needed in institutional agriculture to protect farmers and maintain the regularity of agricultural activities, starting from the production process to agricultural products marketing. The form of institutions in agriculture can be translated into reality by the existence of farmers' groups which is the main actor in rural agricultural development. The role of farmers' groups can be in the form of providing farming business inputs, capital, irrigation water, information and marketing results collectively [8]. ]Institution of farmers' groups shall be established from existing local structure and institutional network, so that it can be structurally and culturally accepted by the local community. Unfortunately, institution that is weak and incompatible with the articles of association (AD/ART) of farmers' groups is one of the problems faced by farmers' groups [16].

### 2.2 Linkage Program

Based on the Regulation of the State Minister of Cooperatives and Small and Medium Enterprises of the Republic of Indonesia Number 03/Per/M.UMKM/III/2009 regarding Linkage Guidelines for Programs Between Commercial Banks and Cooperatives, Linkage program is cooperation carried out by commercial banks to Microfinance institutions (MFIs) in the form of financing as an effort to increase the activities of Micro and Small Enterprises. This program is a partnership, in which Commercial Banks finance the real sector through partner companies which generally are MFIs. The Indonesian Banking Architecture (API) has issued a generic linkage program model containing the rules for implementing linkage programs between commercial banks and Microfinance institutions; one of which is the establishment of three schemes in the implementation of linkage programs, namely executing, channeling and joint financing. Arifin (2013) states in his research that the pattern of legal relation linkage programs has a strategic foundation, namely (1) it is carried out with a profit sharing mechanism and prohibiting usury so that a more fair and beneficial partnership pattern to all parties is realized; (2) a broad LKMS network; (3) LKMS is easily accessible

to low-income people (4) LKMS' experience in serving small customers makes both parties have specialization advantage in working on the segmentation of small businesses over sharia banks.

### 2.3 Previous Research

Several previous studies with similar themes will be discussed in this sub-chapter. Regarding the implementation of linkage programs through Microfinance Institutions, Pagura and Kristen (2006) stated that the linkage scheme between formal and informal institutions was carried out to provide banking facilities or financial institutions for rural communities and for the institutions themselves. Linkage scheme was considered capable of overcoming each other's weaknesses in terms of achieving the target of each institution. Sulemana and Adjei (2015) stated that financing through Microfinance Institutions had a positive relationship with the agricultural sector and had a significant impact on agricultural production. Furthermore, Sulemana and Adjei (2015) stated that the main challenge of Microfinance Institutions in financing the agricultural sector was farmers' inadequate understanding of credit application procedure.

Another study, Saad et al. (2014) stated that microcredit schemes were able to alleviate poverty and improve farmers' living standards as indicated by increased in production, so that farmers gained a surplus from its production increase and were able to gain maximum profit. Anang, et al (2015) stated that gender, household size, agricultural capital, livestock ownership, and increasing technological adaptation were the determinants of the amount of credit provided. Therefore, it was necessary for Microfinance Institutions to improve its services so that farmers were able to access micro credit facilities for their agricultural products. Ashari (2009) concluded that financing in the agricultural sectors was still minimal which was caused by high risks faced, strict requirements of financial institutions and agricultural businesses management weaknesses of which most of these agricultural businesses were generally micro and small ones.

Mi'raj and Hadi Ryandono (2015) stated that linkage system between banks and *Baitul Maal wa Tamwil* (hereinafter referred to as BMT) was not in accordance with the mudharabah agreement, this mismatch could not be separated from the financing scheme of BMT in which they still relied on mudharabah schemes. Sakti (2013) revealed institutionally, BMT operations required extraordinary improvements in industrial governance and BMT internal aspects such as operations and management. These problems needed to be overcome by strengthening management strategy, administration, and human resources system and maximizing the use of Islamic banking infrastructure in Indonesia.

Regarding the analysis of linkage program policy, in the context of strategic issues implementation, the government has issued various regulations through Bank Indonesia Regulation (PBI) concerning the Minimum Capital Requirement for Commercial Banks Based on Sharia Principles (KPM) and Sharia Short Term Financing Facilities. Nasution and Ahmed (2015) stated that the linkage program between Sharia Banks and Islamic Financial Institutions, especially BMT, had a significant impact on BMT growth, especially on BMT Return on Assets (ROA) using executing model became the best model for implementing linkage programs between Islamic Banks and BMTs. However, the effectiveness of this program also relied heavily on external and internal factors of BMT.

In addition to the linkage program, the role of farmers' groups needs to be improved, one of which is through local wisdom. Hariadi and Widhiningsih (2015) stated that adopting local wisdom in conducting innovations in farmers' groups had a positive and significant effect on rice productivity in the Farmers' Group in Prambanan. Regarding the development of farmers' groups, Santosa Purbayu, B. and Darwanto (2015) stated that institutional problems faced by farmers' groups, especially in Demak Regency, were norms which were not in accordance with the articles of association (AD /

ART). Furthermore, Santosa Purbayu, B. and Darwanto (2015) provided a priority for institutional solutions by optimizing functions and roles in accordance with the articles of association (AD / ART).

### 3. Research Method

This research was performed in Central Java by conducting primary data collection using in-depth interview and focus group discussion (FGD) methods. Secondary data were obtained through literature study of various agencies such as the Central Bureau of Statistics (BPS), the Ministry of Agriculture, the Ministry of Village Development of Disadvantaged Regions and Transmigration, and so forth. The approach used in this study was a qualitative approach. This method was often referred to as naturalistic research methods because the research was carried out in natural conditions (Sugiyono, 2012). Data analysis was done in several stages, namely reduction, data display making, and conclusion drawing.

### 4. Research Findings

Based on the research that has been carried out, namely through in-depth stakeholder interviews, then conducted focus group discussions with several farmers' groups in Central Java, as well as further study through literature study, this study found a formal scheme of capital and institutions governing the course of agricultural sector. The scheme can be seen in Figure. 1. Capital is a problem often faced by farmers that makes them unable to develop their businesses. Therefore, farmers must take part in accessing finance in financial institutions. The condition of generally bankable farmers and long enough distance to take from the village to the city make it difficult for farmers to directly access financing from Islamic banking. The Sharia banks usually focus on customers of upper middle economy class. That is why the difficulties in managing small businesses including the agricultural sector commonly exist in remote areas. For that reason, Islamic banking carries out financing in the agricultural sector using a linkage program pattern through Islamic Microfinance Institutions (LKMS).

Linkage programs have three forms, namely channeling, executing and joint financing. In general, banks implement the form of linkage programs, namely channeling and executing. Linkage programs in the form of channeling are provided by Islamic banking to farmers through LKMS acting as agents / trustees, while executing is form of financing directly distributed by Islamic banks to LKMS. According to Dapta (2012), financing linkage program with executing forms is easier and simpler to apply. This helps LKMS as the second institution in distributing fund, so that financing farmers living far from Islamic banks want to propose as well as those who want to apply it from LKMS for the sake of simpler financing process, can be fulfilled. The linkage program with channeling patterns is more complicated to run. The security and convenience of Islamic banks in financing is indeed more guaranteed, but it takes longer process and more energy to distribute the fund. Consequently, farmers have to wait longer for the disbursement of their applications. From the credit arrangement side, Islamic banking and LKMS use wakalah credit agreement, while the credit agreement used by LKMS with farmers is varied depending on the ability and the farmers' need, namely *musyarakah*, *mudharabah*, *murabahah*, or *ijarah* credit agreements.

There must be a top-down structure that manages the agricultural sector from institutional side. According to Minister of Agriculture Regulation No. 67 / Permentan / SM. 050/12/2016 regarding Farmer Institution Development, farmer institutions are institutions developed from, by, and for farmers to strengthen and fight for the interests of farmers, including Farmers' Groups, Farmers' Groups Union, Agricultural Commodities Association, and National Agricultural Commodities Council. Farmers' Group, hereinafter referred to as Poktan, is a collection of farmers / livestock farmers / planters formed on the basis of common interests; common social, economic and resource environmental conditions; common commodity; and familiarity to improve and develop its members' businesses. The farmers' group has a function to jointly develop farming skills such as learning classes, collaboration and production unit facilities. With the existence of farmers' groups, farming can be performed by sharing of facilities, skills and links. Farming business refers to agricultural

process starting from production / cultivation, post-harvest handling, processing, production facilities, supporting services to marketing of agricultural products.

Certain important things should be available in farmers' group institution are rules or norms that are agreed upon and must be obeyed by members of the farmers' group; the existence of sustainable periodic meeting schedules (eg members meetings, management meetings and others held once a month); the work plan in the form of the Group's Definitive Plan (RDK) and the Group's Need Definitive Plan for (RDKK); well-organized administration; the existence of facilities for joint business activities from upstream to downstream sectors; the existence of commercial and market oriented farming facilities; as a source of information and technology services for the business of farmers in general and for group members in particular and the existence of a network of cooperative partnerships between Poktan and other parties; developing business capital formation, both from members contribution and provision from joint business activities result.

The union of farmers' groups (Gapoktan) is an association of several farmers' groups that join and work together to increase economic of scale and business efficiency. Gapoktan plays a role as a business unit. The realization of gapoktan as a business unit which provides production facilities and infrastructure is by facilitating services for all members in fulfilling the need of production facilities such as fertilizers, certified seeds, pesticides, agricultural machinery, and farming capital both from farmers' self-financing and the provision of joint business activities result. Gapoktan as a production business unit can produce commodities in order to fulfill the needs of its members and market to be able to guarantee products availability in terms of quantity, quality and continuity. Gapoktan as a processing business unit can provide services in the form of the use of agricultural machinery or technology in processing commodity production. For example, sorting or grading and packing to increase product value added. Gapoktan as a marketing business unit can provide services in marketing agricultural products through the development of business partnership networks with outside parties. In addition, Gapoktan also provides commodity price information services to members for them to grow and develop into independent farming businesses. The merging of Poktan into Gapoktan is expected to create strong, independent and competitive farmers' institutions.

The Agricultural Commodities Association is an association of farmers, Farmers' Groups, and / or Farmers' Groups Union working on similar commodities to fight for the well-being of farmers. The purpose of its establishment is to increase the farmers' bargaining position through increasing professionalism in managing farming business. In developing their associations farmers can include entrepreneurs, experts, and / or community leaders who show their concern about the welfare of farmers. Associations can be established in stages from the center to the regency / city area. Some of the duties of the Agricultural Commodities Association include: accommodating and finding an outlet for farmers' aspirations; advocating and supervising the implementation of farming partnerships; providing input to the government and / or regional government in the formulation of policies for protection and empowerment of farmers; promoting agricultural commodities produced by members, domestically and abroad; encouraging fair farming competition; facilitating members to access production and technology facilities; and helping solve problems in farming.

The National Agricultural Commodity Council is an institution consisting of associations of community leaders, farmers and entrepreneurs of the Agriculture Commodities Association, as well as product consumers of both agribusiness goods and services. The main objective of the establishment of the National Agricultural Commodity Council is to fight for the well-being of farmers. Some of the duties of the National Agricultural Commodity Council include: accommodating and channeling the aspirations of the main actors and business actors regarding agribusiness development; providing input to the Government and / or regional government regarding agribusiness development; providing data, information, and input to the government, both the regional government or the first actor and business actor; and supporting mediation among Agricultural Commodities Associations.



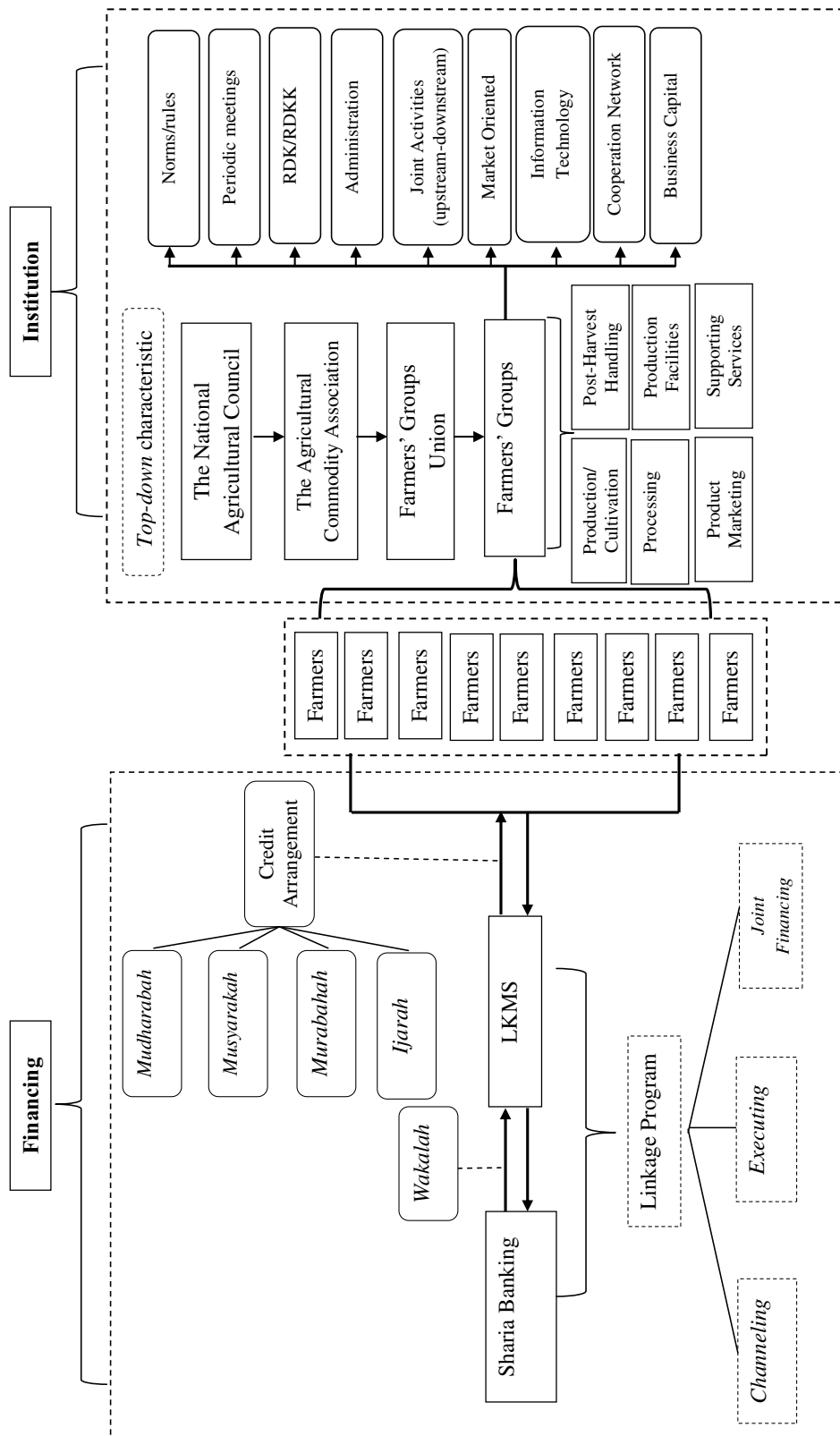


Figure 1. Scheme of Agricultural Sector Financing and Institution

## 5. Conclusion

Based on the research, it can be concluded that: (1) Capital problem in the agricultural sector can be solved by implementing a linkage program pattern among Islamic banking, Islamic Microfinance Institutions (LKMS) and farmers. The application of this pattern will be equally beneficial for the whole parties involved. Possibly applied credit arrangements include *wakalah wal mudharabah*, *wakalah wal musyarakah*, *wakalah wal murabahah*, or *wakalah wal ijarah*. The application of credit arrangements in sharia financial institutions will certainly not harm farmers as they are carried out in accordance with Islamic sharia principles which prioritize cooperation and justice. (2) Institutional strengthening in the agricultural sector is important so that Indonesian farmers are able to compete in both local and global markets. Institutional strengthening is formed with the existence of formal structures from the national to the village level aimed at the farmers' welfare. The formal structures are farmers' groups, farmers' groups union, Agricultural Commodities Association and the National Agricultural Commodities Council. The structure makes it easier for farmers to operate their farming from upstream to downstream, namely from the early stage of production / cultivation, post-harvest handling, processing, to the distribution of business results. For farmers' groups as a forum for developing farmers at the village level, several institutional elements needed are norms, periodic meetings, Groups' Definitive Plan/Groups' Needs Definitive Plan (RDK / RDKK), administration, joint activities, market orientation, information technology, cooperation networks and business capital.

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