Factors Influencing the Low Demand for Salam Financing Contracts in Indonesia – Concept Paper

Mohamad Shahril Isahak[1], Nor Firza Alia Nor Azman[1], Anis Farhana Zaini[1], Nur Sabrina Shaari[1], Emylia Elvis[1] & Mohammad Ishaque Husain[2]

[1] Faculty of Accountancy, Universiti Teknologi MARA, Cawangan Selangor, Kampus Puncak Alam, Selangor, Malaysia

[2] Islamic Banking Division, Bengal Commercial Limited, Dhaka, Bangladesh

Correspondence: Mohamad Shahril Isahak, Faculty of Accountancy, Universiti Teknologi MARA, Cawangan Selangor, Kampus Puncak Alam, Selangor, Malaysia. E-mail: shahrilisahak@uitm.edu.my

Received: March 13, 2023 Accepted: April 19, 2023 Online Published: April 22, 2023

doi:10.5430/afr.v12n2p17 URL: https://doi.org/10.5430/afr.v12n2p17

Abstract

Salam financing is significant in the agricultural sector, especially for seasonal food crops. It has many benefits for the community, particularly for poor farmers, and it is appropriate in the agriculture sector. This paper aims to discuss the factors influencing the low demand for Salam financing contracts that are impactful to either buyer, the bank, or the seller, the farmer. This study adopts a qualitative approach, which includes reviews and analysis of secondary data in relevant literature and documents relating to Salam financing contracts in the Indonesian banking industry. The significant findings of this study are the identification of human resources in Islamic banks that should be improved in terms of their knowledge of Islamic banking products. It is crucial also to know how to innovate for a sustainable and implementable product. In order to address the challenges in Salam financing, it is proposed to reduce internal and external issues with Salam financing. This study adds new knowledge to the existing literature by optimizing the Salam contract in Islamic banking to overcome capital problems in the farming sector and collaborating with agricultural insurance to cover capital costs that farmers cannot pay when crop failure occurs. This study will recommend the methods to overcome the problems stated faced by Islamic banking, including using fintech to counter the issues.

Keywords: salam products, Islamic finance, parallel Salam, Indonesia

1. Introduction

Salam is a contract where the price is paid in advance while the commodities are delivered later. Salam is defined as a sale or contract purchase of a deferred commodity for the current price, bay ajilin bi ajil (Amine, 2008). It means that a Salam agreement is a contract between two parties where the price of the items will be paid in cash on the spot at the time of the delivery of the goods in the future. Salam financing is applied legally to support the agriculture farmer to make sure they have enough money to finance their agriculture for future needs. It involved the bank as Al-Muslam, the buyer, and the farmer as Al Muslam Ilaihi, the seller. Allah the Almighty has stated in the Quran about prohibiting riba (interest), so farmers have difficulties taking usurious loans to support their farms. Therefore, Prophet Muhammad (pbuh) allowed them to sell their farm products ahead of schedule to support the needs of their own and family (Muneeza et al., 2011).

Indonesia's sizable agriculture sector contributes significantly to economic development and food security. Furthermore, agriculture is critical to national economic growth, especially in poverty alleviation, employment opportunities, and farmer welfare, while protecting natural resources and the environment. Figure 1 below shows an increase in the total assets of Indonesian Islamic banks, which increased to approximately 676.74 trillion Indonesian rupiahs in 2021. This amount is not surprising, given that Indonesia has the largest Muslim population in the world. However, only about 7% of Indonesians use Islamic banking products.

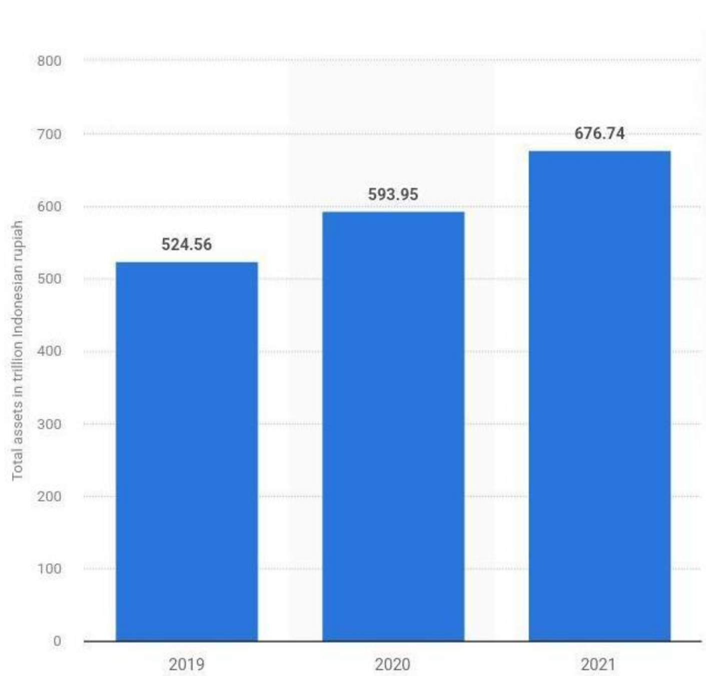

Figure 1. Total Assets of Islamic banks Indonesia 2019-2021 (Source: Statista Research Department, 2022)

According to a report from the Indonesian Financial Service Authority (OJK/Otoritas Jasa Keuangan), the Salam contract for agriculture, one of the uncommon products offered by Indonesia's Islamic banks, represents less than 1% among all financing supplied by Islamic banks (Hudaifah et al., 2019). As a result, Indonesia must take advantage of and extensively use Salam financing. Thus, the agriculture sector in Indonesia mainly applies other financial Islamic products such as Murabahah and Musharakah (Waluyo & Rozza, 2020). Even so, farmers in Indonesia may benefit more from using Salam financing.

1.1 Problem Statement

Salam financing undeniably benefits its users, but demand for this product remains relatively low. Nevertheless, no Islamic bank in Indonesia uses Salam, and Murabahah financing is more popular, accounting for 56% of utilization (Al-Anshory & Jatmiko, 2022). That begs the intriguing question: Is the traditional Salam contract for Islamic finance still applicable in the contemporary economy? Although the Salam contract seems convenient for both parties, either the buyer (Al-Muslam) or the seller (Al-Muslam Ilaih), there are a few risks about the consequences of the Salam contract. As the buyer, the bank faced a significant threat within this deal. The bank may face price risk, in which the cost of commodities may fall during the delivery date; delivery risk, where the seller has the right to refuse agreed-upon delivery; operational risk and natural calamity (Muneeza et al., 2011; Investment & Finance, 2013). This will have an impact on the confidence of the buyers to decide on the Salam financing contract.

1.2 Gap of Research

This paper will discuss what factors contribute to the Salam financing issues that lead to its low demand. The recommendation is in purpose to solve the problem not only faced by the bank but also by the farmer. Apart from that, we also can see how the responsible parties are involved in catering to the issues that arise.

2. Literature Review

2.1 Salam Contract

The contract involved two transacting parties; the buyer (Al-Muslam) and the seller (Al-Muslam Ilaih) (Sulaiman et al., 2019). Usually, the buyer of the Salam Contract is Islamic Bank, and the seller is a small entrepreneur such as a farmer. Financial institutions could also benefit from Salam contracts because the products were delivered at lower set prices as compared to those determined by changes in the market. In exchange, they can make money by selling these products. The typical Salam contract passes through two stages: the Islamic bank pays an advance to the seller for future delivery. After a few years have been agreed upon, the seller will deliver the goods to the bank as promised.

2.2 Parallel Salam

It is a contract agreement that consists of two different and independent contracts; one in which the bank is a buyer and the other in which the bank is a seller (Sulaiman et al., 2019). The process of Parallel Salam happens when the bank binds the Salam contract with the farmer and the third party concurrently. The third party must ensure they are not the same entity as the farmer. Moreover, this binding of the contract with a third party, the farmer, must be well-known. The stages start when Islamic banks make a payment firstly for future delivery. Then the bank receives the payment from the buyer in the Parallel Salam contract. After reaching the agreement date, the farmer delivers the goods to the bank. The bank delivers the commodity to the buyer, the third party in the Parallel Salam Contract.

3. Factors Contributing to Salam Financing Issues

3.1 Operational Issues in Salam Financing

Salam financing has many benefits for the community, particularly for poor farmers, and it is appropriate in the agricultural sector, particularly for seasonal food crops. According to a study, a comparison of all types of financing funding among ASEAN countries was made. The results show that Salam financing has the highest growth potential and significantly impacts economic growth (Pratami et al., 2022). However, the bank frequently encountered a few issues during the operation of Salam financing. It was because there was no capital available after the payment was made, the risk of losing all of the capital or the commodity goods, or the risk of meeting farmers with a bad attitude who sold the yield to another buyer at a higher price (Roziq et al., 2014).

3.2 The Advance Payment and the Capital Availability

The first problem with operating Salam financing is that no capital is available after making the payment advance. In a Salam contract, the buyer will pay the seller in advance (CIMA, 2022). However, they will not receive the commodity at the time of payment as specified in the contract and must wait until the specified delivery date. Farmers will use the money to buy seeds, rent equipment, and so on, and this process will be lengthy, and the crop also needs to wait for a few months to be ready. As a result, the Salam contract appears to pose an obvious risk to the buyer, the bank (Roziq et al., 2014). Banks are still concerned about this risk, but it is natural for any financing product to have risk to be profitable, just like a legal maxim said, "Algurum bil gunm," or "no pain, no gain."

3.3 Crop Failure

Second, there is crop failure, resulting in buyers losing all of their money. Crop failure is usually caused by disease, bad weather, such as the rainy season, or plant pests. Humans cannot control the risk of bad weather, and the damage it can cause is severe. In addition, crop failure also usually occurs because farmers have problems during post-harvest. The post-harvest risk is usually due to crop storage, transportation, harvesting, and milling (Atah et al., 2019). Storage is a vital amenity for farmers to store the harvested crop and maintain its quality. The only way for the bank to secure its assets in Salam financing is for the harvest to be delivered when it matures and be identifiable (CIMA, 2022). However, if the crop is not successful and there is a problem in the planting process which results in poor crop quality, the bank will bear the risk and loss (Hudaifah, 2019). If the bank neglects this factor, both parties, particularly the bank, will suffer significant losses. Financial institutions must consider this situation and provide advice to farmers in order to reduce the risk of crop failure.

3.4 Moral Hazard Farmers and Higher Price

Regarding trust, many risks exist, including the possibility of being cheated. This risk was also present in Salam financing, where farmers stole the money given by the bank and breached the agreement (Muneeza et al., 2011). Moreover, some farmers did not provide the appropriate crops per the agreement. As a result of the loss, banks are hesitant to use Salam. This is a severe problem because human behaviour cannot be predicted, and if no precautions are taken, the bank will suffer a huge loss. Aside from that, the bank may encounter bad farmers who sell the yield to another buyer at a higher price. If the farmers are unhappy with the selling price stated in the contract, they will sell it as crop prices rise, and the worst-case scenario is that the crops are sold to third parties without informing the bank (Waluyo & Rozza, 2020; Roziq et al., 2014). The negative impact of this action on the bank is very significant, and it will cause them to lose trust in farmers. Besides that, the bank/buyer will be unwilling to enter another Salam transaction due to this action. Even though the goal of entering the Salam is to assist poor farmers, the bank can only do something if the seller violates the agreement because it also needs to secure its capital. According to Surah Al-Imran, verse 76 means, "Yea, whoever fulfills his promise and guards (against evil) - then surely Allah loves those who guard (against evil)". Allah clearly instructed the people to keep every promise and agreement. That is why anyone who enters the Salam financing should always adhere to the agreement to benefit both parties.

4. Implementation Issues of Salam Financing in Islamic Financial Institutions (IFIs)

Salam contracts have five vital and essential pillars: the buyer, the seller, the price, the product, and the offer, followed by acceptance. To ensure a legally binding and enforceable contract, strict conditions are applied, such as the reasonableness of delivery and specifications of commodity quality, type, and quantity. Any differences in the quality and quantity of goods and the timeliness of delivery would not affect the agreed-upon price. The kind of sale of the contract is permissible in Islam, as Allah the Almighty has mentioned in the holy Quran:

"O ye who believe! When ye deal with each other, in transactions involving future obligations in a fixed period, reduce them to writing." (Surah Al-Baqarah 2: 282)

However, there are implementation issues throughout the operation of IFIs to provide Salam financings, such as lack of knowledge of human resource management, the existence of other alternative financing agreements, the profit-oriented need for a quick loan, and the Salam agreement is not a priority.

4.1 Lack of Knowledge on Human Resource Management

Human resource is defined as the contribution to maintain and develop the company's market share in all relevant ways (Al-Ghazal, 2010). Human resource management is essential in building a practical application of Salam financing contracts. This is because the insufficient understanding of the Salam financing development idea will result in misunderstandings about the implementation process. This is one of the severe issues in Islamic financing, especially for Salam, since a lack of understanding in the related area may affect human resource management in identifying suitable applicants for employees in the related area of knowledge. Employees with broad knowledge of Salam may only sign a contract involving Salam finance with a complete understanding of its purposes. Human resource is an essential element in the internal management system of an organization because it has an important role in human capital, namely hiring and managing employees for the specific areas of each employee. The hiring process may also need more tests for human resource management to examine the knowledge and capabilities of the applicants, in the area of Islamic financing. These related problems and challenges will lead to insufficient professionals and expertise being hired to oversee the development of the Islamic financing system.

4.2 Existence of An Alternative Financing Agreement

It cannot be denied how alternative agreements in Islamic finance contracts influence users and customers to choose other Islamic financing contracts instead of Salam financing. The existence of other Islamic financing contracts, such as Murabahah, Mudarabah, Musyarakah, Ijarah, Istisna' and other contracts in the market of IFIs may be a challenge for Salam financing since various agreements offer much more specific contracts, without any use of agricultural products. Customers and Islamic Financial Institutions such as Islamic banks have options for various Islamic contracts currently on the market, which they believe to be more focused on safety issues. Most customers will likely believe they may find a better, more direct offer. The Salam financing may only attract farmers and crop owners since they will be made benefit from the agreement of the Salam financing contract. Since Salam is a contract of sale in which the seller agrees to provide the buyer with a certain commodity at a future time in exchange for full payment in advance, the risk for Islamic Financial Institutions such as Islamic banks may be very high since they have to bear any risk of losses if the customers' commodity failed to be in a consistent agreeable condition. Hence, Islamic financial institutions and customers tend to refrain from adopting the Salam financing agreement.

4.3 Profit Oriented

The use of Salam financing as a source of funding may be the bank's objective of maximizing profit. Most agricultural product producers, such as farmers and crop owners, may be short in cash and desperately need any money they can acquire to raise crops. The meaning of Surah Al-Isra' verse 35 spells, "Give full measure when ye measure, and weigh with a balance that is straight: that is the most fitting and the most advantageous in the final determination." The obligation of the Islamic banking business is of a higher calling, not merely for the goal of making profits or only for society and the environment, but also for the creator of all things, Allah the Almighty, according to this verse, which has a beautiful significance when applied to this topic. With a moral compass that assures justice and fairness to maintain sustainability in the economy and society, Islam caters to commercial profit maximization. This demonstrates that it is up to Islamic finance to provide a just and balanced operation and how the weaker members of society should be protected. The concession of Shariah has demonstrated that the Salam financing to safeguard the small and medium-sized farmers who are poor and vulnerable promotes a sensible, balanced, and equitable distribution of wealth.

4.4 Needs for a Quick Loan

Hudaifah (2019) stated that the farmers' weakest negotiating position is their need for an urgent loan. This will contribute to the unsustainability of demand in Salam financing as the farmers will be burdened to fulfill the documents needed for incorporating Salam contracts. Otherwise, the farmers will frequently seek available funds from a third party in the form of repayment of the loan. The situation would be more complicated if the lending party intended to trap the farmers, in this case, the so-called loan sharks that wish to pay little money for the farmers' harvests (Hudaifah, 2019). In addition, they are unlicensed moneylenders who charge incredibly high-interest rates and sometimes use threats and violence to scare people who cannot repay their loans. Furthermore, the lack of actual collateral, such as land ownership documents or automobiles, makes a rapid loan necessary to satisfy the banking requirements for the Salam agreement (Hudaifah, 2019). Moreover, land title is vital, wherein the farmland can be used as mortgage security. This is because collateral and mortgage security will reduce non-delivery or credit risk (Ahmed & Fida, 2020). Therefore, the farmers may submit a piece of real estate or another item as collateral to convince the bank to secure the Salam contract.

4.5 Salam Agreement and Priority-Based Contract

The Salam agreement can be terminated if neither party suffers a financial loss (Sulaiman et al., 2019). The farmer may be tempted to cancel the contract if the market price of contracted goods is higher at delivery than what the bank has paid him. Similarly, if the price of the contracted goods falls at the time of delivery, the bank may tend to rescind the contract. The only exception that may be considered is the commodities' unavailability in the market and inaccessibility to the seller when the bank refuses to extend the delivery period. In addition, selling a commodity before taking possession is prohibited by Shariah. Thus, window banks prefer something other than a Salam contract because it would mean having to take delivery of the goods from their clients rather than paying them. Since banks are solely used to conducting financial transactions, it is against their nature to accept the delivery of various goods from various clients and then resale those goods on the open market (Fahda et al., 2016).

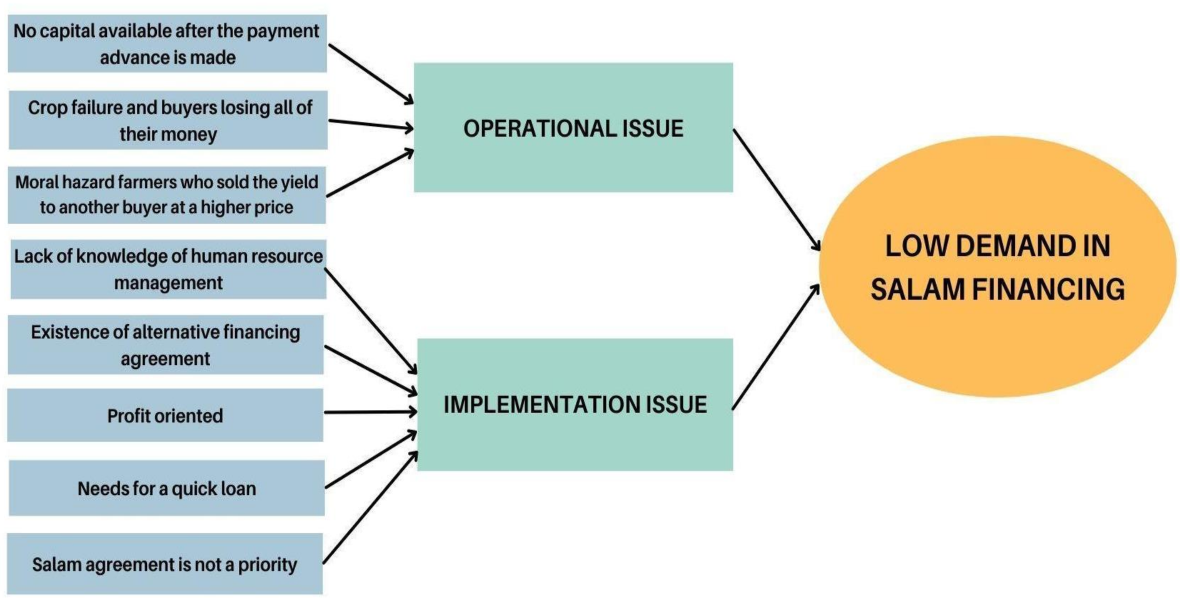

Figure 2. Proposed Conceptual Framework

5. Findings

5.1 Minimizing Problems in Salam Financing

5.1.1 Using Fintech in Salam Financing

Fintech is a tool that is commonly used in financial institutions today. Blockchain, IoT, AI, and other technologies have altered businesses' operations. The use of blockchain technology can improve Salam contracts and make them more innovative and profitable. This also included Salam financing, where the potential of technologies can help to reduce the risk that financial institutions face, particularly the use of blockchain in monitoring user transactions.

Furthermore, Salam operations can be done digitally using blockchain, and there will be automation throughout farming business activities (Muneeza & Mustapha, 2020). Before a bank can participate in a Blockchain-based Salam contract, it must ensure that the agricultural product has a ready market and can engage with a buyer, which requires careful planning. This can be accomplished by utilizing the traceable and auditable function of blockchain. This enables the bank to fully sell the agricultural goods received from the seller (the farmers). In addition, by using blockchain, all parties can monitor and keep updated with the progress. Farmers, logistic partners, insurance firms, and buyers, in addition to the bank, can monitor and track the Salam commodities or subject matter to be delivered. They can easily keep track of the product's progress and keep up with its development until it is ready (Muneeza & Mustapha, 2020). The bank can also advise farmers on how to use this fintech so that they can communicate effectively with one another. As a result, it will increase both the financial institution's and the client's confidence in entering into Salam financing.

5.1.2 The Background Check of the Farmers

When a financial institution decides to enter the Salam financing market, it must conduct extensive background checks on the farmers. Background checks are essential for ensuring that the capital is in the hands of people they can trust. Farmers must meet certain criteria, such as having a good credit bank, being hardworking, owning land, having a positive attitude, and not having a criminal record in financial matters (Waluyo & Rozza, 2020). A tight screening can also help the financial institution avoid entering into farmers with moral hazards, which is one of the issues discussed in this paper. The bank can conduct an interview to determine whether or not the candidate is qualified. Having an expert on hand to assist the bank can also aid in determining whether the farmers are sound and credible. The expertise has more experience in the agricultural field, which will significantly assist the bank or financial institution.

5.1.3 Continuous Education

In relation to the issue discussed, the lack of knowledge on human resource management, it is recommended for continuous education to be adopted. In order to implement education for Islamic banking, stakeholders must maintain an ongoing education program in Islamic financing. The target audience for education should be the workforce of Islamic banks. Human resources in Islamic banks must improve their knowledge of Islamic bank products and how to innovate for a sustainable and implementable product, especially in Salam financing. Education in the area of Islamic banking and finance should be widely offered by universities and colleges in order to innovate for a sustainable and implementable product, especially in Salam financing. This is to ensure that sufficient knowledge might help candidates fully comprehend Islamic finance principles. Training can also be implemented since it is a powerful tool for Human Resource Development (HRD) in order for them to have specific attitudes, skills, and knowledge. In particular, human resources in Islamic banks must improve their knowledge of Salam financing and Islamic bank products to determine how to innovate for a sustainable and implementable product. Even though this paper's originality concerns the thorough screening of the farmers or owners of agricultural companies, ongoing education must be implemented to reduce internal and external difficulties in Salam financing. Prior research has focused on reducing the external problem with financial Salam. However, to decrease the challenges in issues in Salam financing, it is proposed to reduce both internal and external issues with Salam financing.

5.2 Expand Objectives of Salam Financing

Islam prohibits using interest as a means of making money or profit. The feasibility of using the Salam contract, which is an advance sale agreement, as an alternative financing instrument in Pakistan's agriculture industry has been investigated (Kaleem & Rana, 2009). They contended that the concept of Salam can be extended to non-agricultural activities such as cattle and poultry farming. According to Kaleem and Rana's research, the provision of Salam funding can actually be expanded to include the area of animal husbandry, which has the potential to grow. The object of Salam financing can be a source of funding that would balance maximizing profit and fulfilling its function as a social organization as in aiding the underprivileged. The majority of agricultural product producers are cash-trapped. They are underfunded, and in desperate need of any kind of money they can acquire to provide for their families. Hence, Salam financing should undoubtedly help the populace in need and, at the same time, will be a profitable product for the bank, provided that it is created in a way that balances the interests of both sides.

5.2.1 Do Group Salam Financing

In order to influence the farmers not to get involved in the quick loan scheme, community groups of farmers can be established to discuss the experience with each other to build awareness regarding the features of Salam financing.

Furthermore, they can share their insights on the progress and benefit of the Salam contract. Waluyo and Rozza (2020) reported that the government needs to implement policies that can boost financial inclusion or information in order to promote the growth of agricultural finance, such as Salam contract workshops. Moreover, joint responsibility may be used if one farmer experiences crop failure. Therefore, when one member encounters challenges, the other members also assist in completing the tasks by adhering to the group's agreement.

5.2.2 Collaborate With Agricultural Insurance

An alternative to implementing the Salam financing agreement for agriculture in Shariah banking can also help to alleviate the low demand for Salam, which was introduced by Muhammad et al. (2017). The research is based on the concept of maximizing the Salam contract in Islamic banking to address capital issues in the agricultural sector by partnering with agricultural insurance to cover capital costs that farmers cannot bear when crop failure happens. This is undoubtedly a sigh of relief for the application of the Salam in Islamic financial institutions, which has previously been done due to the risks they face. Islamic insurance, also known as takaful, will cover the risks that arise during the Salam financing process. Hence, the bank will avoid the risk of loss associated with the Salam financing contract provided to farmers. Islam does not permit unilateral profit maximization (Aziz & Osman, 2016). As a consequence, Islamic banks must adhere to fundamental Islamic principles such as engaging in "non-interest-based transactions," protecting the rights of competitors and consumers, and promoting corporate social responsibility, even though they will be profit-driven, just like any other types of business (fair-trade, environment-friendly production, labour rights). The eventual success of a business will contribute to the abolition of societal issues such as poverty. Farmers' well-being is expected to improve due to Salam finance provided by Islamic institutions.

6. Conclusion

A Salam financing contract is between buyer and seller, mainly between the farmer and the bank. For farmers to gain money while waiting for their agriculture farm to harvest, they seek the money to support their own life. The bank is responsible for providing the capital in this Salam financing contract. Unfortunately, most banks faced a few challenges in holding this agreement, making it hard to accept the Salam financing contract. In this paper, we discussed the factors that contribute to the low demand for Salam financing contracts in Indonesia that are impactful to either the buyer, the bank, or the seller, the farmer. The issues faced by Salam financing contract holders have contributed to low demand. The uncertainty of the consequences makes the bank difficult to make a decision to support the Salam financing contract. As the farmer cannot assure their crop, the environment impacts unexpectedly. Besides that, most of the farmers barely noticed the operations of Salam financing. Therefore, the effectiveness of Salam financing to be conducted decreases in demand. Although various issues arise regarding Salam financing, a few actions and recommendations have been taken to cater to these issues. In conclusion, the low demand for Salam financing has depended on the issues that arise within the operation itself, and recommendations must be successfully implemented.

Acknowledgement

The authors would like to express their gratitude to the Faculty of Accountancy, Universiti Teknologi MARA, Malaysia, for funding and facilitating this research project.

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