Interest-free Loan as an Alternative to Traditional Credit: Evidence from Agriculture and SME Practitioners among Muslims in the Ampara District

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Abstract

This study investigates the use of interest-free loans Qard Hasan (QH) as an alternative to traditional lending among Muslim agricultural and SME populations in the Ampara District of Sri Lanka, a major paddy production region. Many farmers of the region rely on pawning to cover capital shortfalls during farming seasons. Using qualitative method approach, based on primary field survey data and secondary empirical literature, the study discovered that farmers require significant amount of capital each season, with pawning loans providing the majority of the funding gap. A village-based microcredit institution, founded on Islamic social finance basis, has covered approximately 54% of this gap through interest-free loans. Evidence suggests that QH reduces the financial burdens of vulnerable people resulted from interest-based loans while also encouraging trust and cooperation, making it a viable, culturally appropriate financing option for entrepreneurs, particularly in the agriculture and SMEs sectors. The study shows that this methodology could be expanded to other regions to safeguard disadvantaged farmers from predatory lending markets and poverty traps.

Keywords: *Ampara District, Interest-free loans, Qard Hasan, Al Masraful Islamiyyu, Islamic social finance.*

1. Introduction

Access to affordable, ethical financing remains a critical challenge for many agricultural and SME practitioners, especially within Muslim communities where conventional interest-based credit is discouraged due to religious prohibitions. Qard Hasan (QH), an interest-free loan as an important element of Islamic social finance concept rooted in Islamic economic policy, offers a promising alternative by providing financial support without interest burdens. This study focuses on the Ampara District of East Coast of Sri Lanka, where the Muslim population heavily depends on agriculture and SMEs. Paddy farmers are categorized into four

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groups: attached labourers working on others' land, small scale (<2 acres) land owners, medium (2-5 acres), and large (>5 acres) farmer households, often called podiyars (Lebbe, 2012).

According to Ahamad (2018), this region's farmers face multiple challenges generating sufficient income from paddy cultivation, compounded by rising input costs. Income from paddy alone rarely covers household expenses, forcing farmers to seek credit. Despite the critical role of agricultural credit in improving yields and adopting modern techniques, many struggle to obtain and repay formal loans. Consequently, they become trapped in cycles of high-interest debt, relying on pawnbrokers and informal creditors. Strong Islamic ethics in the region heighten wariness toward conventional interest-based loans.

The Qur'an encourages Muslims to provide QH to those in need, promising manifold rewards (Al-Qur'an 57:11; 64:17). Prophetic traditions further commend giving QH, rewarding donors generously (Ibn Majah, 1972).

2. Problem statement

Structural barriers and religious prohibitions make conventional interest-based lending inaccessible or unsuitable for Muslim agricultural and SME practitioners in the Ampara District, despite their pressing need for capital. Consequently, many resort to high-interest informal credit sources such as pawning, which deepen cycles of poverty and indebtedness. While Qard Hasan (interest-free loans) offers a promising alternative aligned with Islamic principles, empirical evidence on its effectiveness, accessibility, and sustainability in this rural setting remains limited. This study aims to explore sustainable, financially inclusive, and culturally sensitive financing solutions that can reduce reliance on exploitative lending and foster economic empowerment in the region.

3. Conceptual Framework

This study uses a qualitative framework to understand the shift from conventional pawning to Islamic social finance among smallholder farmers and the SMEs operators, focusing on institutional dynamics and socio-cultural factors shaping financial decisions.

Structural constraints like seasonal capital shortages and limited access to interest-free institutions drive farmers to pawning, which provides liquidity but imposes heavy interest burdens. Islamic social finance, particularly QH, offers a community-based alternative addressing financial and ethical concerns.

Strong religious adherence, social trust, and community participation enhance acceptance and reduce default risk, sustaining the system. This transition results in reduced indebtedness, improved livelihood stability, and greater agricultural productivity. The framework illustrates how socially embedded financial innovation can disrupt exploitative credit systems and alleviate rural poverty.

This conceptualization provides a holistic understanding of financial behaviour and institutional change, aligning with the qualitative nature of the study.

Accordingly, this study is grounded in several theoretical perspectives that elucidate the functioning of rural credit markets and the role of alternative financial systems.

The **Theory of Credit Market Imperfections** offers a fundamental explanation for the exclusion of smallholder farmers from formal financial institutions. According to Stieglitz and Weiss (1981), information asymmetry between lenders and borrowers leads to adverse selection and moral hazard, causing credit rationing. In agricultural settings, these challenges are intensified by income uncertainty, lack of collateral and high transaction costs, which make formal lenders hesitant to extend credit to small farmers.

The **Financial Inclusion Theory** underscores the importance of accessible and affordable financial services to foster inclusive economic development. Conventional financial systems often fail in this regard due to profit-driven lending practices that prioritize low-risk borrowers. Alternative models, such as microfinance, attempt to fill this gap, although traditional microfinance institutions have faced criticism for charging high interest rates.

Crucially, the study draws on **Islamic Economic Theory**, which is rooted in principles of social justice, risk-sharing, and the prohibition of riba (interest). Within this framework, Qard al-Hasan (QH) represents a benevolent financing system designed to promote equity and mutual support. Unlike conventional lending, QH emphasizes welfare expansion over profit maximization, aligning financial activities with ethical and social objectives.

Additionally, **Social Capital Theory** helps explain the success of community-based Islamic finance institutions. Trust, shared norms, and religious values foster better repayment behavior and reduce default risk (Dusuki & Asyraf, 2008). In tightly knit communities, these informal enforcement mechanisms effectively substitute for formal collateral requirements.

Finally, the **Poverty Trap Theory** provides insight into how high-interest debt mechanisms, such as pawning, can trap farmers in cycles of poverty. When farmers rely on costly credit, a significant share of their income is diverted to debt servicing, limiting their ability to build assets and invest productively. Interest-free financing models, therefore, have the potential to break this cycle.

By integrating these perspectives, the study conceptualizes Islamic social finance as a viable institutional innovation that addresses both market failures and socio-economic inequalities in rural credit systems. Through exploring the use and impact of QH among practitioners, the research aims to demonstrate how this form of financing can enhance economic sustainability, foster social trust, and promote inclusive growth. Understanding QH's role is essential for developing tailored financial solutions that respect cultural and religious values while supporting economic development regionally and nationally.

4. Objectives of this study

To make this study fruitful, and beneficial for the both demand and supplies sides, as well as policy makers and social activists, its relies on the following objectives;

1. To examine the challenges faced by Muslim agricultural and SME practitioners in accessing enough capital for their entrepreneurial activities in the Ampara District.
2. To explore the role of Qard Hasan (interest-free loans) as an alternative financing model aligned with Islamic principles in supporting agricultural and SME activities.
3. To assess the impact of Qard Hasan financing on reducing financial stress, indebtedness, and improving business sustainability among the target societies.
4. To compare the effectiveness of community-based Islamic social finance institutions with conventional pawning and formal lending systems in meeting seasonal capital needs.
5. To identify challenges and limitations in the accessibility and administration of Qard Hasan loans and propose recommendations for enhancing their reach and sustainability.

6. To contribute empirical evidence on the potential of Islamic social finance as a tool for financial inclusion, poverty alleviation, and economic empowerment in rural Muslim communities.

5. Materials and Methods

5.1 Empirical Literature

The concept of Qard Hasan (QH), or interest-free loans, is deeply rooted in Islamic finance principles, emphasizing ethical lending without profit derived from interest (riba), which is prohibited in Islam (Khan & Bhatti, 2008). Research indicates that QH fosters mutual support and solidarity within Muslim communities, serving as a socially responsible financial tool (Usmani, 2002).

In the context of agriculture and SMEs, access to conventional credit is often limited by high interest rates and stringent collateral requirements (Beck et al., 2005). QH provides an alternative aligned with religious beliefs, making it more acceptable and accessible to Muslim entrepreneurs (Chapra, 2008). Studies across various Muslim-majority regions demonstrate that QH improves financial inclusion, reduces indebtedness, and enhances business sustainability (Iqbal & Mirakhor, 2011; Obaidullah, 2005).

However, challenges such as limited awareness, administrative capacity, and sustainability concerns affect interest-free lending schemes (Farooq & Zaheer, 2015). Despite these obstacles, evidence suggests QH plays a critical role in supporting vulnerable sectors like agriculture and SMEs by providing ethical, interest-free financial resources (Siddiqui, 2008).

Literature on agricultural finance in developing economies consistently highlights persistent credit constraints faced by smallholder farmers, leading to reliance on informal mechanisms such as pawning and moneylenders. Early studies (Bouman & Houtman, 1988) identify pawning as a dominant rural credit instrument where formal institutions fail to reach marginalized populations. Similar findings from Asian and African contexts show informal credit markets remain active due to their accessibility and flexibility.

Nevertheless, these informal mechanisms often involve high implicit or explicit interest costs, contributing to cycles of indebtedness and poverty. Access to formal agricultural credit correlates strongly with farm size, excluding small-scale farmers and reinforcing dependence on costly informal sources (Kumar et al., 2010; Yegoh, 2014).

Recent empirical work on Islamic microfinance shows promising results. For example, Muneer and Khan (2022) found that QH significantly reduces multidimensional poverty in Bangladesh by improving capital access without interest burdens. Similarly, Ali (2024) documents how Pakistan's Akhuwat Foundation's interest-free loans boost agricultural productivity and reduce resource inefficiencies.

In Sri Lanka, empirical research on Islamic social finance, especially at the community level, remains limited. Existing studies (Lebbe, 2012; Ahamad, 2018) focus on income, expenditure, and credit constraints among paddy farmers, highlighting severe financial gaps and reliance on pawning. However, comparative analyses of conventional pawning and Islamic microfinance models are scarce.

Furthermore, although studies recognize the socio-religious compatibility of Islamic finance in Muslim-majority regions, there is a lack of sufficient empirical evidence regarding its scalability, sustainability, and effectiveness in replacing deeply entrenched conventional financial practices, including both formal and informal pawning.

This study contributes by providing micro-level empirical evidence on how a community-based Islamic social finance institution reduces reliance on pawning and addresses seasonal capital shortages in agriculture. It fills a critical gap by comparing profit-driven conventional lending with welfare-oriented Islamic finance within a rural setting.

5.2 Methodology

5.2.1 Research Question

This study employs a mixed-methods approach to examine the use and impact of QH among agricultural and SME practitioners in the Eastern Province. Building on Ahamad's (2018) findings that farmers face challenges such as insufficient cultivation capital, marketing difficulties, and inadequate income to cover household expenses, this research investigates whether Islamic social finance offers a feasible alternative. The central research question is: Does Islamic social finance provide a relevant solution for the area's financial challenges, and how can it be improved to meet community needs?

Quantitative data were collected through structured surveys of a representative sample of Muslim practitioners involved in agriculture and SMEs. Qualitative data were gathered through semi-structured interviews and focus group discussions to explore experiences, perceptions, and challenges related to QH financing.

5.2.2 Sampling

Purposive sampling selected participants who accessed or were aware of QH loans, ensuring relevance to research objectives. Key informants included Islamic social finance experts, conventional bank pawning officers, farmers, podiyars[4], vatta-vithanas[5], the management board of "Al Masraful Islamiyyu[6]," a social finance institution founded for community service. Additionally, discussions were held with rice mill operators, and mosque trustees for further clarifications. The study also reviewed printed materials and journal articles on Islamic microfinance, conventional pawning, and agricultural loans in similar contexts. Descriptive and thematic analyses were employed to fulfil the study's objectives.

5.2.3 Data Analysis

Interviews encouraged participants to share experiences with conventional and Islamic lending systems. All participants consented to digital recording. Quantitative data were statistically analyzed to identify patterns and correlations between conventional credit, QH usage, and outcomes. Qualitative data were thematically analyzed to capture nuanced perspectives on the benefits and limitations of interest-free loans. This mixed methodology provides a comprehensive understanding of how QH functions as an alternative credit system and its implications for financial inclusion and economic empowerment among Muslim practitioners.

6. Results and Discussion

6.1 Data and Results

[4] It is a system that structures agricultural society around relationships between landowners and retainers or labourers in exchange for a specific percentage of the specific yields.

[5] The person in charge of a particular section of the paddy fields oversees the efficient operations of cultivation, irrigation, crop protection, harvesting, and related tasks on behalf of all the local farmers.

[6] An Islamic social finance institution, providing interest-free micro loans for agriculture and SME activities…

Agriculture serves as the primary source of income for approximately 65% of residents in the study region. Farmers are categorized into three groups: podiyars (landlords), mid-sized landowners, and labourers. Historically, landlords have exerted significant influence, as most livelihoods depended on agriculture.

Given the unavoidable need for credit, particularly pawning as a microcredit mechanism, Islamic social finance institutions providing interest-free loans (QH) have partially succeeded in shielding farmers and SME operators from the detrimental effects of interest-based lending, as reflected in respondents' testimonies.

One small-scale farmer in his sixties explained, "Previously, a cultivation season required around 200,000 LKR, but now I need at least 800,000 LKR. I once relied heavily on pawning with high interest rates, but now the Islamic social finance institution has alleviated that burden."

Another farmer in his fifties described transitioning from pawning jewellery with high-interest pawn brokers to borrowing through Al Masraful Islamiyyu, an Islamic social finance institution, by depositing gold and repaying only the principal without interest as; *"We were pawning our jewelleries with pawn brokers to manage the capital shortage, after the harvesting, sell our yields, settle the loan and release at high interest rate. However, with Al-Masraful Islamiyu (social finance institution) we may now borrow money with a gold deposit and repay it with just the capital. Because of this institution does not charge any access to the borrowed capital."*

A single mother, a widow affected by ethnic conflict, stated, *"We borrow based on immediate needs, for consumption or productive purposes. We pay a nominal service charge between 500 and 1,000 LKR, and upon repayment, we may choose to donate extra to support the institution or repay only the capital. In addition, if we are unable to repay the loan by the due date, the institution provides us some extensions at no cost*".

A bakery owner shared, *"When I started my business, I had limited capital. Upon learning about Al Masraful Islamiyyu, I requested financial support, which was processed quickly. This enabled me to expand my bakery and open a successful grocery shop."*

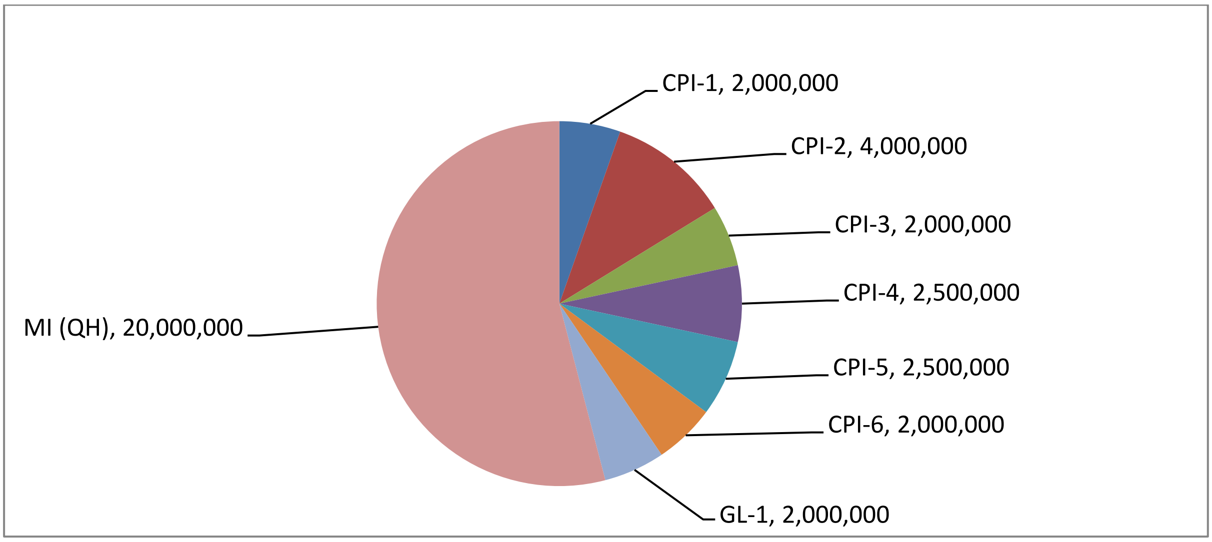
Another respondent involved in both agriculture and SME activities noted, *"The Islamic credit system has been instrumental in my livelihood. It helped me manage farming, while my wife established a handloom business, creating multiple income sources and moving us toward self-sufficiency."*

An auditor for Al Masraful Islamiyyu, a state cooperative development officer, reported, *"Throughout the institution's history, there have been no significant unresolved loans. Beneficiaries view the institution as essential and engage with loyalty."*

The Chairman of Al Masraful Islamiyyu shared about their journey in the institution, *"We started in 1996 with less than 0.7 million LKR. Today, liquidity has grown to about 1.5 billion LKR to assist those in need under Islamic social finance principles. Our beneficiaries experience real prosperity and relief from financial burdens through Sharia-compliant transactions, earning full community support to continue as a state-approved social service entity."*

These narratives reflect insights from diverse stakeholders including beneficiaries, agricultural instructors, podiyars, pawning institution employees, and Islamic social finance officials.

Summary of Pawning Activity in the Sample Area



Source: Field survey data MI= Al-Masraful Islamiyyu (Islamic social finance institution)
CPI= conventional pawning institution GL= Gold loan (Islamic Bank)

The field survey data illustrate the average daily volume of pawning loans during the second half of the paddy cultivation season. The data show that six major conventional pawning institutions, an Islamic commercial finance institution, and a community-based Islamic social finance institution play central roles in addressing farmers' capital shortages.

Notably, the community-based Islamic social finance institution has grown to cover approximately 54% of the capital needs of farmers and SME operators, significantly reducing reliance on interest-based pawning. The institution's chairman expressed optimism about achieving full coverage with continued community support.

6.2 Major Findings

- **High Acceptance and Trust:** Most participants expressed strong trust in QH due to its alignment with Islamic principles, making it a preferred alternative over conventional interest-based loans.
- **Financial Relief:** Recipients reported reduced financial stress and lower debt burdens, as interest-free loans facilitated easier repayments and improved cash flow, helping mitigate poverty.
- **Business Sustainability:** Many linked QH financing to enhanced business continuity and growth, citing access to funds without interest pressure or collateral requirements such as land titles, which are often unavailable.
- **Social Cohesion:** QH's community-based nature strengthened social ties and cooperation, supported by charitable contributions and volunteer deposits.
- **Challenges:** Some participants noted limited availability and awareness of QH, difficulties accessing loans without gold collateral, and a per-account borrowing ceiling of 200,000 LKR.

Overall, the evidence supports QH as a culturally sensitive, ethical, and practical alternative to traditional interest-based credit for supporting agriculture and SMEs.

6.3 Discussion

The study reveals that farmers in the region face a seasonal capital shortage exceeding 2.5 billion LKR. Commercial financial institutions are generally reluctant to lend to small-scale farmers due to geographic dispersion, market linkages, high costs, lack of collateral, and trust issues, consistent with global literature (Hendri, 2016).

Access to agricultural credit often depends on farm size, excluding smallholders and reinforcing dependence on costly informal credit sources like pawning (Yegoh, 2014; Kumar et al, 2010). This situation highlights significant concerns regarding the lack of access to credit for needy farmers and SME operators, pointing to difficulties in credit market accessibility for these groups.

Pawning provides a quick and easy credit technique that lowers borrower capital shortages and lender risk. Despite the removal of some obstacles, curiosity is still a major problem because Islamic teachings specifically forbid it. Banks and microfinance institutions are examples of traditional financial institutions that continue to charge interest. Pawning is at odds with Islamic economic theory, yet it is consistent with conceptions of social capital and financial inclusion. For recipients in precarious socioeconomic situations, such financial inclusion strategies might not be feasible. Interest-based credit is further complicated by the high level of religious observance among the population in the survey area. This emphasizes how difficult it is to grant credit while upholding both religious and economic inclusivity.

Al Masraful Islamiyyu, an Islamic social finance institution offering interest-free loans, has expanded rapidly due to community support and high repayment loyalty. This growth corresponds with a gradual decline in conventional pawning use as people shift to interest-free alternatives. As of 2024, the institution operates five branches with over 20,000 members, holding approximately 1.5 billion LKR in liquidity. It offers loans up to 200,000 LKR per account secured by gold deposits, with families able to hold multiple accounts, enabling borrowing up to one million LKR interest-free for six-month terms which enabled the institution to diminish above 54% of conventional interest-based pawning loans the village people.

Flexible arrangements exist for borrowers facing repayment difficulties, with few cases requiring such measures. The institution's efficient operations are widely appreciated for their positive impact on local economic growth. Borrowers voluntarily contribute extra funds to support on-going operations.

The reduction in financial stress and improved business sustainability highlight how interest-free loans can alleviate common challenges faced by small businesses and farmers, such as high-interest burdens and cash flow constraints. This supports previous research emphasizing the socio-economic benefits of Islamic finance tools in promoting equitable growth (Iqbal & Mirakhor, 2011).

Furthermore, the role of QH in fostering social cohesion points to its potential in strengthening community networks, which is essential for collective economic resilience. However, the identified challenges—such as limited access and administrative issues—suggest a need for more structured frameworks and increased awareness to expand the reach and sustainability of QH programs.

These findings underscore QH's effectiveness as a culturally appropriate and financially sound alternative to conventional credit, supporting economic empowerment and poverty alleviation in the Ampara District.

Overall, the study advocates for policy support and institutional development to integrate QH more effectively into the financial ecosystem, enabling it to serve as a robust alternative credit system that respects religious principles while driving economic empowerment.

7. Conclusion

This study demonstrates that Qard Hasan (QH), an interest-free loan mechanism, offers a viable and ethical alternative to conventional credit for Muslim agricultural and SME practitioners in the Ampara District. By aligning with Islamic principles, QH enhances financial inclusion, reduces debt burdens, and supports business sustainability. Its positive social impact—particularly in fostering trust and community cooperation—further strengthens its role in the local economy. Addressing challenges related to awareness, accessibility, and administrative capacity will be essential to expand its benefits. Ultimately, QH presents a promising model for culturally sensitive and sustainable financing that empowers farmers and entrepreneurs, and contributes to regional economic development, as well as a potential tool to mitigate poverty influence.

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