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The Development of Islamic Financing Scheme for SMEs in a Developing Country: The Indonesian Case

Aulia Nurul Huda*

Prasetiya Mulya Business School, Edutown Kavling Edu I No.1Jln BSD Raya Barat I BSD City, Tangerang 15339, Indonesia

Abstract

Small Medium Enterprises (SMEs) have significant role in employment creation and growth of gross domestic products of developing country. In the case of Indonesia, SMEs account for more than 90 percents of all company and in employment [1]. However, in order to grow and contribute more significantly to the economy, SMEs face some constraints. One of the main constraints faced by SMEs is the lack of finance. Islamic bank financing products may help to solve this problem. The Islamic participatory schemes, such as *mudharabah* and *musyarakah*, integrate assets of lender and borrowers; therefore, they allow Islamic banks to lend on a longer-term basis to projects with higher risk-return profiles and, thus, to support economic growth. However, as Islamic banks try to avoid uncertainties, the mentioned schemes are not widely used. Therefore, support from government and academia needed to create innovation in the participatory financing scheme so that all related parties can share mutual benefits. Using Indonesia data, the paper analyzes data from Indonesia's National Agency of Statistics and Central Bank of Indonesia and reviews key literature and secondary data on Indonesian SMEs and Islamic banks. In the end, the paper offers a framework in which Islamic financing scheme could be used to solve financing problem faced by Small and Medium Enterprises (SMEs) in the context of developing country.

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* Corresponding author. Tel.: +62-21-304-50-500; fax: +62-21-304-50-555.
E-mail address: aulia.nurul@pmba.ac.id

1. Introduction

It is without doubt that Small and Medium Enterprises (SMEs) hold important roles in emerging markets. Tambunan (2006) states that the important roles of SME can be defined as follow [2]:

- a. Dispersed widely in rural area and play important role in rural economy,
- b. Able to employ a lot of labours from the local economy, and
- c. Provide opportunity to develop entrepreneurial and business skills,

However, SMEs in emerging market face some problems in their development. One of them is the lack to financial support. This financing problem faced by SMEs will be the main focus of this paper. The main objective of the paper is to discuss the possibility of implementing Islamic profit sharing scheme in providing funds to small and medium enterprises.

2. Methodology

As its methodology, the paper reviewed key literature on SMEs, particularly in Indonesia, and also the current practice of Islamic financing in Indonesia. To gain this knowledge, the paper utilized secondary data provided by National Agency of Statistics and Central Bank of Indonesia. The paper first discuss the Islamic banking system and its current practice in Indonesia. The paper tries to give insights of why there is certain pattern occur in current practice of Islamic banking. It is hoped that by the end of this section of literature review, the reluctance of Islamic banks in entering profit sharing scheme can be explained.

The paper then will try to explore the characteristics needed by SMEs for their financing. After gaining knowledge on Islamic bank behaviors and the characteristics of financing needed by SMEs, the paper will analyze the problems that may occur if the Islamic profit-sharing scheme to be applied in the providing financial access to SMEs. After the problems are identified, a framework involving the business, academia and government will be proposed to overcome the problems identified.

3. Islamic Banking System and Practice

3.1. Islamic Banking System

The Islamic banking system (IBS) is defined as a banking system whose principles underlying its operations and activities are founded on Islamic or Syariah rules [3]. Since its first establishment in 1960s, Islamic banking has shown remarkable development considering the system is relatively new compared to conventional banking system first established nearly 420 years ago. International Monetary Fund noted that by the end 2007, there were 300 financial institutions whose operations based on Syariah principles spread in 75 countries. It also estimated that by the end of 2007, the increase in asset value of Islamic banks exceeded 15% per annum with estimated total asset value of Islamic financial institutions worldwide was about \$250 billion [3].

A unique feature of Islamic banks is its profit and loss (PLS) scheme which are usually conducted through the principle of *mudharabah* (profit-sharing) and *musyarakah* (joint-venture). As the assets and liabilities of lenders and borrowers are integrated in this scheme, this unique feature, in theory, allows Islamic banks to lend on a longer-term basis to projects with higher risk-return profiles and, thus, to promote economic growth [4][5]. However, though experts in Islamic economics and finance generally more recommend profit/loss sharing scheme over other trading modes, *murabaha* has been extensively used by Islamic institutions as its permissibility is beyond doubt.

Murabaha can be defined as a 'cost-plus sale', in which parties bargain on profit margin over the known price [6]. Because of its debt-like nature, *murabaha* is mostly used as an alternative to the conventional modes of credit. In Indonesia, by the end of 2010, *murabaha* financing instrument has been used for more than 55,01% of financing given by Indonesian Islamic banks while the percentage for *musyarakah*, *mudharabah*, and other modes of financing were 21,45%, 12,66 %, and 10.88% [7].

The dominance of debt-like instruments in investment financing was also accompanied by several facts that seem to prevent Indonesian Islamic banks to perform its role to improve social welfare of the society. From the data of Indonesian Banking Statistics for the period 2007-2010, we can see the following facts: compared to Indonesian conventional banks, Indonesian Islamic banks charged higher margin for its financing; the Islamic banks also more preferred to give short-term financing as working capital financing with maximum one year credit period dominated the financing they have given; Also, almost 74% of their financing were given in the form of micro, small, and medium credits; However despite the higher margin and the diversification in micro, small, and medium credits, the nonperforming financing of the Islamic banks was higher than the conventional banks.

Given the data above, it seems that Islamic banks in Indonesia have not fully *Shariah*-compliant as they use more of *murabaha* or debt-like instruments rather than profit and loss sharing instruments. Also, despite the majority use of the short-term-period financing and diversification to micro, small, and medium credits, the Islamic banks seem to bear more risks compared to conventional banks as they have higher nonperforming financing.

3.2. Current Practice of Islamic Banking in Indonesia

Though experts in Islamic economics and finance generally more recommend profit/loss sharing scheme over other trading modes, *murabaha* has been extensively used by Islamic institutions as an alternative to the conventional modes of credit. In Indonesia, by the end of 2010, *murabaha* financing instrument has been used for more than 55,01% of financing given by Indonesian Islamic banks while the percentage for *musyarakah*, *mudharabah*, and other modes of financing were only 21,45%, 12,66 %, and 10.88% [7].

Given the data above, it seems that Islamic banks in Indonesia have not been fully *Shariah*-compliant as they use more of *murabaha* or debt-like instruments rather than profit and loss sharing instruments. This phenomenon was also accompanied by several facts that seem to prevent Indonesian Islamic banks to perform its role to improve social welfare of the society:

1. Indonesian Islamic banks charged higher margin for its financing.

Calculated from Indonesian Banking Statistics 2010, from the period of 2008 to 2010, Indonesian Islamic banks charged higher margin for its financing as can be seen on the table below (presented in percentage):

Table 1. Margin of Financing Charged by Conventional and Islamic Banks (in %)

| Type of Usage | 2008 | | 2009 | | 2010 | | Average | |
|-------------------------|-------|---------|-------|---------|-------|---------|--------------|--------------|
| | Conv. | Islamic | Conv. | Islamic | Conv. | Islamic | Conv. | Islamic |
| Working Capital | | | | | | | | |
| IDR | 14,63 | 19,34 | 13,27 | 17,15 | 12,66 | 16,50 | 10,14 | 17,66 |
| Other Currencies | 6,44 | 4,26 | 5,02 | 12,55 | 4,17 | 9,63 | 3,91 | 8,81 |
| Investments | | | | | | | | |
| IDR | 13,99 | 18,04 | 12,05 | 14,22 | 12,08 | 14,06 | 9,53 | 15,44 |
| Other Currencies | 7,01 | 2,23 | 5,88 | 7,65 | 5,39 | 7,60 | 4,57 | 5,83 |
| Consumption | | | | | | | | |
| IDR | 15,82 | 14,32 | 15,81 | 11,4 | 13,69 | 11,13 | 11,33 | 12,28 |
| Other Currencies | 3,85 | 0,01 | 0,67 | 0,13 | 1,59 | 0,69 | 1,53 | 0,28 |

2. Indonesian Islamic banks more preferred to give short-term financing. This phenomena can be seen from the fact that working capital financing with maximum one year credit period has become the dominant financing in the financing the Islamic banks have given:

Table 2. Financing of Islamic Banks Based on Type of Usage

| Type of Usage | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | Average |
|------------------------|-------|--------|--------|--------|--------|--------|--------------|
| Working Capital | | | | | | | |
| Amount | 7.988 | 10.405 | 15.656 | 20.554 | 22.873 | 31.855 | 51,4% |
| Share | 52,4% | 50,9% | 56,0% | 53,8% | 48,8% | 46,7% | |
| Investments | | | | | | | |
| Amount | 4.288 | 4.374 | 5.637 | 7.907 | 9.955 | 13.416 | 21,9% |
| Share | 28,2% | 21,4% | 20,2% | 20,7% | 21,2% | 19,7% | |
| Consumption | | | | | | | |
| Amount | 2.956 | 5.666 | 6.652 | 9.734 | 14.058 | 22.910 | 26,7% |
| Share | 19,4% | 27,7% | 23,8% | 25,5% | 30,0% | 33,6% | |

Source: Indonesian Islamic Banking Statistics, December 2010

Note: Amount in Billion IDR

3. More than 70% of their financing were given in the form of micro, small, and medium credits.

Table 3. Financing of Islamic Banks Based on Type of Financing

| Type of Financing | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | Average |
|---|--------|--------|--------|--------|--------|--------|--------------|
| Micro, Small, and Medium Financing | | | | | | | |
| Amount | 10.196 | 14.872 | 19.565 | 27.063 | 35.799 | 52.570 | 72,3% |
| Share | 66,9% | 72,7% | 70,0% | 70,9% | 76,4% | 77,1% | |
| Non-MSM Financing | | | | | | | |
| Amount | 5.036 | 5.573 | 8.379 | 11.132 | 11.087 | 15.611 | 27,7% |
| Share | 33,1% | 27,3% | 30,0% | 29,1% | 23,6% | 22,9% | |

Source: Indonesian Islamic Banking Statistics, December 2010

Note: Amount in Billion IDR

4. The nonperforming financing (NPF) of the Islamic banks was higher than the conventional banks nonperforming loans (NPL).

Table 4. NPL and NPF of Conventional and Islamic Banks

| | 2007 | 2008 | 2009 | 2010 |
|---------------------------|---------------|---------------|---------------|---------------|
| NPL - Conventional | 4,07% | 3,20% | 3,31% | 2,56% |
| NPF - Islamic | 4,26% | 3,95% | 4,01% | 3,02% |
| Difference | 4,54% | 18,95% | 17,62% | 15,25% |
| Average | 14,09% | | | |

Source: Indonesian Banking Statistics, December 2010

3.3. Phenomena Analysis of Indonesia Islamic Bank Practice

From the explanation above, it can be concluded that Indonesia Islamic banks:

1. charged higher margin for its financing;
2. more preferred to give short-term financing;
3. gave more than 70% of their financing in the form of micro, small, and medium credits;
4. have nonperforming financing (NPF) that was higher than the conventional banks' nonperforming loans (NPL).

These phenomena are not new phenomena in Islamic banks. Some previous researches have tried to explain those phenomena. They tried to explain those phenomena using what is known as asymmetric information.

Asymmetric information or also known as information asymmetry occurs when one party has more information than another party in a transaction. This condition may lead to moral hazard that occurs when the party with more information about its actions or intentions has a tendency or incentive to behave inappropriately from the perspective of the party with less information or to adverse selection that occurs when bad or risky products are more likely to be selected.

In credit contract, asymmetric information between lenders and borrowers, couple with risk aversion or limited liability, generally makes best outcome unattainable. The presence of risk aversion or limited liability means that the borrowers usually do not bear the full cost of very bad outcomes of their investment projects. But, if borrowers are partially insured against bad outcomes, they have an incentive to take advantage of asymmetric information between themselves and lenders by borrowing only if they know their projects are risky (adverse selection) or by taking risks on the projects they undertake (moral hazard). These difficulties cause lenders to charge a premium on their loans [8].

In Islamic banking, previous researches have suspected that adverse selection is responsible for the higher margin charged by Islamic banks. Due to high information and monitoring cost, to overcome the asymmetric information, Islamic banks charge higher margin; however, it makes the fund borrowers who came to the Islamic banks are likely the ones who have been rejected by the conventional banks. As they have no other choice for financing, they came to Islamic banks that charged higher margin. However, these borrowers are likely to be the risky borrowers as they may have been rejected by the conventional banks due to their risk profile; Therefore, Islamic banks by charging higher margin get those risky borrowers that have been turned down by the conventional ones.

As for moral hazard in Islamic banking, the research by Aggarwal and Yousef (2000) best summarizes the phenomena. The research finds that for reasonable level of moral hazard, markup contract will be Islamic banks' preference. It is a rational choice as the banks has asymmetric information. Also, when debt and equity contracts

can be used, debt instruments will be short-term in nature. Banks will also prefer low-cost investment projects. In order to obtain funds for more costly projects, entrepreneurs have to show their low propensity of risks [9].

From the explanation above, regarding the asymmetric information and phenomena stated in problem statement, their relationship can be constructed as follow:

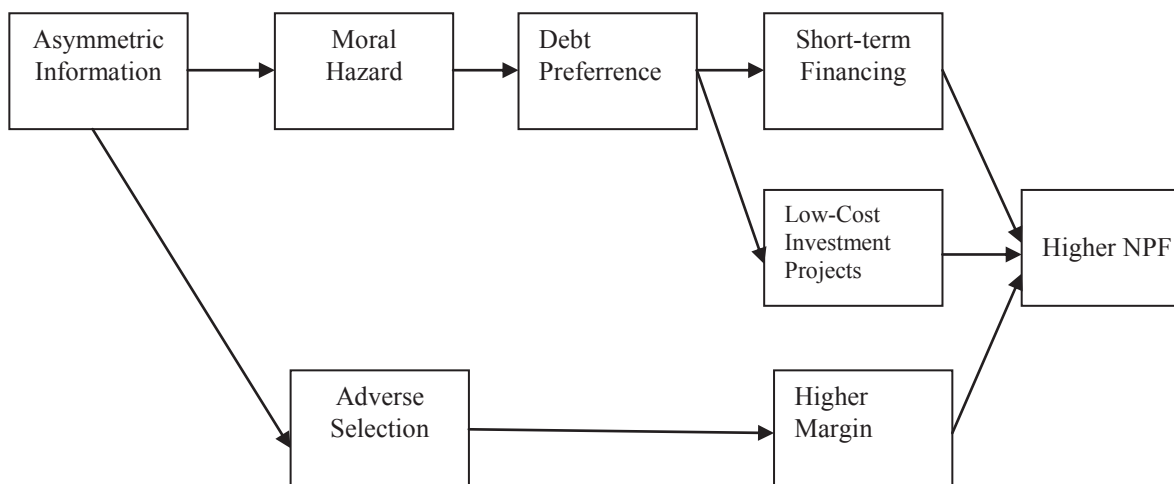


Figure 1. Relationship between Phenomena and Asymmetric Information

In Indonesia, the condition explained above, especially concerned with diversification to low-cost investment projects, may also be linked to the government regulation that gives limitation to the capability of a bank in financing activity. The amount of financing that a bank can give is limited to its capital. Thus, with limited capital compared to conventional banks, Islamic banks may more focus to smaller-scale financing in the form of micro, small, and medium credits.

Also according to Indonesia Sharia Bank Outlook for the year 2011, Islamic Banks tends to have high nonperforming financing as their stakeholders put pressures on the banks to achieve the targeted growth. Due to the pressure, many banks tend to neglect prudent banking principle that, in the end, lead to nonperforming financing. According to the outlook, credit risk will still become the focus of Central Bank supervision as Islamic banks still struggle to have ideal system in controlling credit risks [10].

From the explanation above, we can conclude that due to the conditions surroundings them, e.g. pressure from stakeholders and limited financing capability, Islamic banks tends to neglect prudent banking principle and therefore have asymmetric information on their borrowers. However, they want to minimize their risks and gain high profitability by charging higher margin.

Back to the explanation of adverse selection, the charge of higher margin will tend to attract borrowers that have been rejected by banks that more strictly apply prudent banking principle, in this case conventional banks. Therefore, the borrowers who come to Islamic banks are the ones who indeed have higher risk profile. So, in this case, the Islamic banks selects their customers from the pooling of bad or risky customers. Therefore, applying higher margin on the financing will not help the banks to overcome operational risks as their customers are mostly come from those with higher risk profile. Applying higher margin will only make higher probability to have nonperforming financing.

5. Small Medium Enterprises in Emerging Markets

According to McKinsey Report 2012, emerging markets Micro-, Small, and Medium Enterprises (MSMEs) is a very attractive segment as it provides the opportunity for the bank to growth on compounded basis at the rate of 20% making the bank revenues increase from \$150 billion in 2010 to an estimated number of \$367 billion by 2015 [11]. However, there are challenges in grasping this market that can be stated as follow:

- The potential MSME clients are widely dispersed
- Low revenue per client
- High risks of credit losses
- Physical presence to lend to MSMEs

Also, the reports states that the MSME segments requires such characteristics for their banking services:

- Simple products and services. The MSME clients needs simple products and process. They require quick process for their service. Therefore, for example, the application form may not be more than two pages.
- Unsecured loans even if they have to pay at higher price. MSMEs are willing to pay higher interest rates for unsecured loans. They indeed value if the bank can provide them with such credits.
- Trustworthy and convenient channels. What is considered as trustworthy in the context is face-to-face communication. MSME clients offer required physical presence of bank officer especially in the beginning of the relationship.

Besides the insights of MSME clients, the report also offered insights of what bank think in grasping the opportunity of MSME market. The banks consider the following factors:

- MSME clients are strategically important. The banks believe that if it is managed well, the segment can be profitable.
- MSME loan are forecasted to grow strongly. Most of the bank agree that MSME segment will be likely to grow at 20% per annum, while their expected losses from this segment is predicted only at the rate of 5%.
- Poor data and poor business cases hinder the banks from lending to MSMEs. The availability of data becomes constraints for the banks to lend to MSMEs.

6. Islamic Financing Scheme For SMEs

From the explanation in the previous section, we can see that assymetric information is one of the reasons of why Islamic banks preferred debt-like instruments to profit-sharing scheme. It is also one of the reason of why bank charge higher margin for their financing. On the other hand, the SME clients will not mind the higher margin charged as long as they can get loan from the bank in a quick procedure. The customers in this segment demand simple products and services.

From the explanation above it can be seen that Islamic banks can fulfill the needs of SME segment for funds. Let alone, the government regulation in Indonesia limit the amount of financing the bank can give to its capital. With limited capital compared to conventional banking, it seems reasonable for Islamic banks in Indonesia to give financing in forms of micro-, small, and medium financing. In fact, more than 70% of Indonesia Islamic Bank financing is given in this form. To avoid severe competition with conventional banks, Islamic banks may choose MSME segment that are still untapped by the conventional banks. Also, Islamic banks should use more of profit-sharing scheme as the Islamic participatory schemes, such as *mudarabah* and *musarakah*, integrate assets of lender and borrowers; therefore, they allow Islamic banks to lend on a longer-term basis to projects with higher risk-return profiles and, thus, to support economic growth.

To utilize Islamic financing schemes in SME financing, one of the problem that should be overcome is assymetric information. The government can play roles in decreasing the assymetric information by doing the following:

- a. Act as strategic partner for Islamic bank to identify the potential SMEs. As SMEs are widely dispersed, the government, particularly the local government, can help the banks to identify not only the location of SMEs,

but also the viability of the business. The government should have database of SMEs in their region. To survive in SME market, the banks must reduce its operational costs. If government can provide reliable data on SMEs, it will help the banks to lower its operational costs.

- b. In assessing the viability of the business, the government should work together with academia to create innovative credit scoring for SME valuation. The credit scoring should allow the banks to quickly assess the risks of the business. If the government and academia can work together in providing such scoring system, the banks will be able to provide the financing products with simple bureaucracy without neglecting prudent banking principle.

If the collaboration between the businesses, particularly the Islamic banks and SMEs in this contexts, the academia and the government can be made in that way, the financing scheme for SMEs that are more suitable for their needs can be provided. This will lead to development of SMEs that in the end will promote economic growth for the country as more than 90% of employment are provided by SMEs.

7. Conclusion

Government along with academia should act as strategic partner for Islamic banks in reducing asymmetric informations that prevents the bank from lending to SMEs. Government should provide data on the widely dispersed SMEs so that the bank can easily find them. Also, the viability of the business must be evaluated. Due to its research-nature, academia can help in improving credit scoring system that will allow government to value the viability of the SMEs and also the banks to value the risks of the businesses. Government should have database of SMEs in its region. This will allow the government act as strategic partner for the banks in its financing distribution to SMEs. Only when the asymmetric information is reduced, the Islamic profit sharing scheme can be implemented for the growth of SME. For further research, the nature of liquidity risks and other risks in Islamic banks should be investigated to see their impacts in distributing financing to SMEs. This research is mainly focusing on operational risks and how to lower operational costs in distributing financing to SMEs.

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