



**A SHARI'AH EVALUATION ON MICRO FINANCING
PRODUCTS IN ISLAMIC BANKS IN INDONESIA**

BY

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ABSTRACT

Indonesia is home to the largest Muslim majority financial market in the world, and has a highly complex micro finance and rural finance sector which has evolved over the last century. Interestingly, micro financing services have always accounted for the largest component of financing activities extended by Islamic banking institutions in Indonesia, due to the fact that the majority of Indonesian people are in the middle to low level income category. This study highlights the history and development of micro financing in Islamic Financial Institutions (IFIs) in Indonesia and attempts to evaluate the shariah aspects in micro financing products in Indonesian Islamic banks which covers 7 (seven) Islamic banks and 15 (fifteen) Islamic rural banks (BPRS). There are five major contracts that are used in micro financing products in Indonesian Islamic banks which are *murabahah*, *ijarah*, *mudarabah*, *musharakah* and *rahn*. In Indonesia, until June 2012, the *murabahah* contract still dominated as the instrument of choice for Islamic banks that uses micro financing for MSMEs (Micro, Small and Medium Enterprises) comprising of 56% of the total financing portfolio. Interestingly, the contract of *qard* (loan without interest) increased significantly from only IDR1.829 trillion in 2009 to IDR12.937 trillion (12%) in 2011. This study discusses and evaluates the shariah compliance of micro financing products in Islamic banks in Indonesia in accordance with the *fatwas* of DSN-MUI (National Shariah Board Indonesian Council of *Ulama*), Bank Indonesia Regulations (PBI), and classical *fiqh* doctrines. This study indicates that the majority of micro financing products in Islamic banks in Indonesia comply with Fatwa DSN-MUI and Bank Indonesia Regulations. However, there are some relevant shariah issues that need to be further addressed despite their compliance with shariah regulations issued by DSN-MUI and Bank Indonesia, including combination of contracts and selling gold on installment which is clearly prohibited in a hadith of the Prophet Muhammad (pbuh).

خلاصة البحث

تعتبر دولة إندونيسيا من أكبر الأسواق العالمية للمسلمين، التي تمتلك مشاريع تمويلية صغيرة، بالإضافة إلى قطاع التمويل الريفي المتطور، وذلك منذ فترة زمنية طويلة. علاوة على ذلك، فإنَّ مشروعات التمويل الصغيرة لا تزال تعتبر أداة قوية للتخفيف من الفقر، والذي يؤدي بدوره إلى توفير الخدمات المالية للفقراء وذوي الدخل المنخفض. تلقي هذه الدراسة الضوء على تاريخ التمويل الأصغر وتطوره في المؤسسات المالية الإسلامية في إندونيسيا، وتحاول تقييم منتجات المشروعات الصغيرة من الناحية الشرعية لدى سبعة من البنوك الإسلامية وخمسة عشر بنكاً إسلامياً ريفياً. وهناك خمسة عقود رئيسة مستخدمة في منتج التمويل الأصغر في البنوك الإسلامية في إندونيسيا لتلبية الطلبات على القطاع الصغير والمنتجات الصغيرة، والتي تتمثل في: المرابحة، والإجارة، والمضاربة، والمشاركة والرهن. وقد تمَّ إدراج ميزانية يونيو 2012 في إندونيسيا، وتبين منها أنَّ عقد المرابحة لا يزال يهيمن على صك البنوك الإسلامية التي تستخدم لتمويل المشاريع الصغيرة للمنشآت بنسبة 56٪ من إجمالي محفظة التمويل. ومن المثير للاهتمام، زيادة عقد القرض (القرض بدون فائدة) بشكل كبير، حيث ارتفع من 1.829 تريليون في عام 2009 إلى 12.937 تريليون (12٪) في عام 2011. وتحاول هذه الدراسة تقييم منتجات التمويل الأصغر في البنوك الإسلامية في إندونيسيا، وهل تسيّر وفقاً لقواعد الشريعة الإسلامية ومبادئها، وذلك في ضوء فتوى الهيئة الشرعية الوطنية لمجلس العلماء الإندونيسي (DSN-MUI) وتنظيم بنك إندونيسيا (PBI)، والفقهاء الإسلامي الكلاسيكي. ويشير البحث إلى أنَّ غالبية منتجات التمويل الأصغر في البنوك الإسلامية في إندونيسيا قد امتثلت لفتوى DSN-MUI و PBI. ومع ذلك، فإنَّ هناك مجموعة من القضايا الشرعية التي تحتاج إلى معالجتها، رغم أنَّ عقودها امتثلت مع أحكام الشريعة التي صدرت من قبل DSN-MUI و PBI. بما في ذلك مجموعة من عقود منتج الرهن الذهبي، الذي تكتنفه الكثير من المخاطر بشكل واضح؛ نظراً إلى الأحاديث النبوية المتعلقة به؛ حيث حرّم النبي الجمع بين قرض وبيع في صفقة واحدة، وكذلك بيع الذهب على أساس مؤجل، بينما نجد في منتجات التمويل الأصغر إمكانية الجمع بين القرض وعقد الإجارة في صفقة واحدة، وبيع الذهب على أساس مؤجل في منتج الرهن الذهبي.

APPROVAL PAGE

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DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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Muhammad Iman Sastra Mihajat

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LIST OF ABBREVIATIONS

AAOIFI	Accounting Auditing Organization for Islamic Financial institution
Bapepam-LK	Badan Pengawas Pasar Modal dan Lembaga Keuangan non Bank (Islamic Capital Market and Financial Institution Supervisory Board)
BCA	Bank Central Asia
BI	Bank Indonesia (Central Bank of Indonesia)
BKK	Badan Kredit Kecamatan
BNI	Bank Negara Indonesia
BNIS	Bank Negara Indonesia Syariah
BMI	Bank Muamalat Indonesia
BMM	Baitulmaal Muamalat
BMT	Baitul Mal wa al-Tamwil
BPR	Bank Perkreditan Rakyat
BPRS	Bank Pembiayaan Rakyat Syariah (Islamic Rural Bank)
BRI	Bank Rakyat Indonesia Mandiri
BRI-UD	Bank Rakyat Indonesia – Unit Desa
BRIS	Bank Rakyat Indonesia Syariah
BUKP	Badan Usaha Kredit Pedesaan
BUR	Bina Usaha Rakyat
DKI	Daerah Khusus Istimewa
DPS	Dewan Pengawas Syariah
DSN-MUI	Dewan Syariah Nasional Majelis Ulama Indonesia (National Shari‘ah Board of Indonesian Council of <i>Ulamā</i>)




GB	Grameen Bank
IFIs	Islamic Financial Institutions
IMFIs	Islamic Micro Finance Institutions
KJKS	Koperasi Jasa Keuangan Syariah
KLM	Kepemilikan Logam Mulia
KUM3	Komunitas Usaha Mikro Muamalat Berbasis Masjid
KUR	Kredit Usaha Rakyat
LDKP	Lembaga Dana Kredit Pedesaan
LKMS	Lembaga Keuangan Mikro Syariah
LKURK	Lembaga Kredit Usaha Rakyat Kecil
LKP	Lembaga Kredit Pedesaan
LPD	Lembaga Perkreditan Desa
LPK	Lembaga Perkreditan Kecamatan
LPUK	Lembaga Pembiayaan Usaha Kecil
LPN	Lumbung Pitih Nagari
MF	Micro Finance
MSMEs	Micro, Small, and Medium Enterprises
OJK	Otoritas Jasa Keuangan (Financial Services Authority)
PAS	Pembiayaan Al Salaam Syariah
PBI	Peraturan Bank Indonesia (Bank Indonesia Regulations)
PSKKB	Pembiayaan Syariah Kepemilikan Kendaraan Bermotor
PKSM	Pembiayaan Kepemilikan Sepeda Motor
SE-BI	Surat Edaran Bank Indonesia (Circular Letter of Bank Indonesia)
SMEs	Small, Medium and Enterprises




ARABIC TRANSLITERATION SCHEME

Consonants

ء	(hamza)	,		ض	(dad)	d
ب	(ba')	B		ط	(ta')	t
ت	(ta')	T		ظ	(za')	z
ث	(tha')	Th		ع	(‘ayn)	‘
ج	(jim)	J		غ	(ghayn)	gh
ح	(ha')	h		ف	(fa')	f
خ	(kha')	kh		ق	(qaf)	q
د	(dal)	d		ك	(kaf)	k
ذ	(dhal)	dh		ل	(lam)	l
ر	(ra')	r		م	(mim)	m
ز	(zay)	z		ن	(nun)	n
س	(sin)	s		و	(waw)	w
ش	(shin)	sh		ه	(ha')	h
ص	(sad)	s		ي	(ya')	y

Vowels

	short <i>fathah</i>	a		long <i>fathah</i>	ā
	short <i>kasrah</i>	i		long <i>kasrah</i>	ī
	short <i>dammah</i>	u		long <i>dammah</i>	ū

- *Tanwin*    is represented by *an, in, un* respectively.
- Transliteration will involve only Arabic words. Others will be written in *italics*.

CHAPTER ONE

BACKGROUND OF THE STUDY

1.1 INTRODUCTION

Islamic banking and finance has been experiencing an impressive development in recent years. It is one of the fastest growing industries and has spread to all corners of the globe and at the same time receiving wide acceptance by both Muslims and non-Muslims alike. The desire of contemporary Muslim communities to implement shari'ah laws and principles in their daily activities, especially in their economic activities, is one of the reasons why it is being adopted widely (Iqbal & Molyneux, 2005).

Today, Islamic financial institutions (IFIs) are engaged in business with nationwide networks and in a large variety of enterprises ranging from banking, capital market, insurance, mutual fund, leasing, pawnshop institutions, and other financial institutions. Islamic banking is showing an impressive development; it is estimated to have an asset with commercial banks globally in the ballpark of \$1.3 trillion by 2011, suggesting an average annual growth of 19% over the next four years. The Islamic banking growth story continues to be positive, growing 50% faster than other banking sectors. High potential international markets in different stages of development and therefore requiring different penetration strategies include Saudi Arabia, Malaysia, Qatar, Turkey and Indonesia. Ernst & Young (2013) have postulated that Islamic banking assets are to grow beyond the milestone of \$2 trillion by the year 2014. Islamic banking currently operates in more than 75 countries, including Indonesia as the largest countries in the world with the highest Muslim

populations. The Islamic banking system exists not only in Muslim countries but also in European, American, and Asian countries (Taylor, 2007).

In Indonesia, the asset of Islamic banking grew to 37% in 2012 with total assets reaching Rp174.09 trillion, thus enlarging its market share to 4.3% of the national banking market share. In 2013 Islamic banking assets increased continuously to Rp229.5 trillion. If it is combined with the Islamic rural bank (*Bank Pembiayaan Rakyat Syariah*, BPRS), the Islamic banking asset will reach Rp235.1 trillion or 4.8% of the national banking market share (Bank Indonesia, 2014).

Indonesia is one of the largest countries in the world apart from China, India, and United States of America. Indonesia is one of the countries which has been experiencing a high rate of poverty. The percentage of the population below the poverty line was around 17.75% in 2006 (BPS, 1 July 2009). Islamic banking and finance expected to play a major role as a micro finance institution (MFI) which is essential to reduce poverty by providing financing to micro and small enterprises, and at the same time it has a vital role in helping to reduce unemployment and poverty levels in Indonesia. By providing financing to small and medium enterprises to create personal and family business, the poverty level in Indonesia can be reduced.

Meanwhile, Sandiaga Uno the chairman of Industry and Trade of Indonesia (*Kamar Dagang Indonesia*, KADIN) stated in 2010 that Indonesia needs around 4.4 million enterprises including microenterprise to achieve the expected economic growth (Depkop, 2013). Due to this reason, KADIN provides motivation to Indonesian enterprises, including the microenterprise, so as to help them expand their business productivity. He is optimistic that Indonesia can achieve the goal of having the ratio of micro enterprises to the total population in 2010 to be 5%. These days the

total percentage of Indonesian local enterprise is only around 0.18% of the total population, i.e. 200 million (Detik, 2010).

The importance of microenterprises has made it the focus of Indonesia's development policy, particularly improving and broadening their access to financial sources (APEC, 2003). Recently, OJK (*Otoritas Jasa Keuangan*, Financial Services Authority)¹ has been trying to promote financial inclusion to all financial institutions in order to help more people receive/understand financial services by educating people in finance. Financial inclusion means financial access for all people. Making it of Strategic Value to OJK because it can help reduce poverty and boost social welfare. The objective of this strategy is to help micro and small enterprises located in Indonesia who have no collateral and knowledge where the access to the bank is closed. This strategy will be regulated by OJK and this initiative will be a model of how to build a business for micro entrepreneurs so as to be more open accessed to them. It is a fact shows that approximately 40% of Indonesian people have access to financial services. Improving access to financial institutions would address financial problems of unbankable people. The target of OJK is to answer any question of financial services access especially to non-educative people, the service will be supported by encouraging Islamic insurance company to issue the micro-insurance product for micro, small and medium entrepreneurs (Investor, 13 September 2013).

Nowadays, it is very challenging to overcome poverty issues and low levels of social and economic development especially in Muslim countries. Islamic finance

¹ Since the last 2012, Indonesia has come with the new act pertaining to banking supervision (Act No 21 year 2012), previously, banking supervision is come under Central Bank of Indonesia BI, since this act issued, the banking supervision no longer under Central Bank but move into OJK, not only supervise banking industry, but also capital market, insurance, and other Islamic finance that offered Islamic financial services.

provides micro product to finance the small and micro business entrepreneurs to alleviate poverty across the world (Dusuki, 2008). The emergence of microfinance with appropriately designed financial products and services has enabled the poor to expand and diversify their business activities, increase their incomes, combat poverty, and improve their economic well-fare as well as the prosperity of the *ummah* (Benett, & Cuevas, 1996). In the case of Indonesia, Islamic banking has taken a major role to finance the small and micro business in order to stabilize economic development and reduce social inequality. Not only that, this role also taken by BMT (Baitul Maal wa al-Tamwil) and Islamic Cooperative (*Koperasi Jasa Keuangan Syariah*, KJKS) all over Indonesia where the focus is on small and micro business entrepreneurs. Therefore, microfinance becomes an important product in Islamic banking to help and assist the poor in overcoming poverty especially in Indonesia that has a very high population with low levels of income.

Many proposals have been raised and research has been done to propose Islamic banking to help in poverty eradication and the increase in the economic welfare of the society (Rahman, 2007; Dusuki, 2008; Mihajat, 2010). Recently, the majority of Islamic banks in Indonesia are channeling their funds through Islamic microfinance institutions such as BMT, Islamic Rural Bank (*Bank Pembiayaan Rakyat Syariah*, BPRS) and Islamic cooperative to finance the small and micro business activities in villages and the small areas (Republika, 25 October 2012).

Bank Syariah Mandiri came up with the *Warung Mikro* model for micro and small business financing to help finance small and micro businesses as well channeling funds to Islamic micro finance institutions (Bank Syariah Mandiri, 2012). Bank Muamalat Indonesia come with a product called LKM Syariah Financing Product (*Lembaga Keuangan Mikro*, LKM, Micro Finance Institution) to channel the

funds to micro entrepreneurs through Islamic micro finance institutions and working capital financing to finance the small and micro business directly. Not only to maximize the role, Bank Muamalat Indonesia also establish so called Baitulmaal Muamalat (BMM) to finance the very small micro financing to many villages in Indonesia (Bank Muamalat 2012). Majority of Islamic banks in Indonesia compete for the role of financing the micro and small business industry, which promises a huge profit for Islamic banking sector rather than finance a big company (Republika, 25 October 2012).

One of the problems faced by microenterprise is access to credit, particularly from commercial banks. Only 12% of microenterprises are able to obtain financing from commercial banks. There are several reasons why commercial banks are reluctant to finance the poor. Some of the reasons are (APEC, 2003):

- 1) Banking Products do not match the needs and conditions of the micro people,
- 2) Banks often over estimate lending risk to the micro people,
- 3) High credit transaction cost for the micro people,
- 4) SMEs are not able to fulfill banking technical requirements,
- 5) Limited access of the poor to equity financial,
- 6) Inefficiency in monitoring and collecting of the micro people creditor,
- 7) Less effective of technical assistant and still should be provided by the bank itself, therefore service cost for the micro people is high and,
- 8) General bank is not used to finance the micro people.

Commercial bank have also been known to limit financial access to the poor through technical banking requirements, especially for collateral and other

administrative requirements (APEC, 2003). Sandiaga also expects that the interest rate for microenterprise in Indonesia banking could be lowered to 10%. He further stated that in 2010 the interest rate for microenterprise is around 14%-16% in Indonesia. These interest rates can be categorized as high for microenterprise in Indonesia. Thanks to high interest rates, some microenterprises find it difficult to expand their business's productivity. Timberg (1999) added that formal financial institutions are sometimes a critical missing factor in supporting or promoting the SMEs (Small and Microenterprises) growth. He also added that many Indonesian SMEs do not have access to financial services for which they would be willing to pay (Depkop, 2010).

Therefore, Microfinance Institutions (MFIs) have emerged as an important alternative source of financing for new microenterprises. MFIs exist because of the reluctance of banking institutions to deliver micro financing to microenterprises which might lack the capability for repayment. The establishment of MFIs has become an important factor in encouraging the development of microenterprises. MFIs help the microenterprises by (APEC, 2003):

- 1) Increasing business activity of microenterprises by providing working capital or investment fund, and
- 2) Promoting and developing the spirit of entrepreneurship.

Other than that, MFIs not only provide small financing for the poor and but they also provide financial services such as savings, insurance, pensions and payment services (Wrenn, 2005). They are commonly associated with small and micro working capital financing that are channeled to microenterprises or income generating activities (Guntz, 2011). In Indonesia, the most common micro financing products that are provided by Islamic micro finance institutions (IMFIs) and conventional micro

finance institutions are the following: income-generating loans, linkage program, emergency and consumption loans, housing loans, leasing, saving, insurance, and payment services (Seibel, 2004/2005).

Such enterprises are at times based out of a home, such examples are small retail kiosks, sewing workshops, carpentry shops, and market stalls (Whole Planet Foundation, 2009). The typical users of microfinance services are traders, street vendors, small farmers, service providers (hairdresser and rickshaw drivers), artisans; and small producers, such as blacksmiths, and seamstresses; who all belong to the economically active poor and low-income entrepreneurs (Ledgerwood, 1999).

The 1980s became a turning point in the history of microfinance when MFIs such BRI (Bank Rakyat Indonesia) and Grameen Bank began to provide small financing and saving services profitably on a large scale and attain outreach to clients (Wrenn, 2005).

According to Miyashita (2000), Bank Rakyat Indonesia (BRI) was established in 1970s and has demonstrated the potential growth of microenterprise in the country through the BRI Unit Desa (UD) concept started in 1984 (Bramono et al., n.d.). The BRI Unit Desa (UD) concept are used to channel and mobilize the fund at high interest rate to microfinance clients and Cooperatives in many villages, and in district and sub-district areas. BRI is the first commercial bank in the world to provide commercial financial services such as savings, loans, as well as other products to millions of economically active poor and lower-middle income households, and do so profitably (Robinson, 2005). BRI-UD system is a system provided by BRI to deliver microcredit to microenterprises in villages and districts area and has been profitable every year since 1986 is now an integral part of Indonesia's financial system (Miyashita, 2000).

Grameen Bank (GB) was the first bank to offer micro financing and thus it dominates the market in Bangladesh. The system was pioneered by Muhammad Yunus in 1976 who was the founder of GB. In Bangladesh, GB has over three million members and it has been estimated that over 10 million people have received financial services from the bank. In fact, the financial initiative made by GB formed the basic fundamental for micro financing which was then extended to other countries. Today, the practice of microfinance has been is being replicated by other countries such as India, Indonesia, Asia, Africa, and Latin America (Harper, n.d.). Yet problems still remain, for BRI and GB are the microfinance initiative were still in its conventional form which according to Islamic law is prohibited.

The number of MFIs increased and burgeoned in the 1990s and was thus known as the “microfinance decade”. The importance of microfinance in the field of development was reinforced in 1997 with the launch of the Microcredit Summit the same year. The summit aimed to reach 175 million of world’s poorest families by the end of 2015 (Microcredit Summit, 2005).

The Indonesian government has now realized the importance of MFIs in providing micro finance to microenterprises. It encourages the growth of MFIs especially based on the shari’ah principles. Within the Indonesian banking sector are banks such as Islamic Commercial Bank, Islamic windows, and BPR Syariah (Islamic Rural Bank); as well as Islamic cooperatives, BMT (*Baitul Māl wa al-Tamwīl*), BTM (Baitu al-Tamwīl), and Koperasi Syirkah Muamalah which under the supervision of Pusat Inkubasi Bisnis Usaha Kecil (PINBUK), (Antonio, n.d.).

Islamic banks in Indonesia committed to the empowerment of SMEs as one of the formal objectives include Bank Muamalat Indonesia, Bank Syariah Mandiri, Bank Mega Syariah, Bank BRI Syariah, Bank BNI Syariah, Bank CIMB Niaga Syariah,