ISLAMIC BANKING BUSINESS MODEL AS SOLUTION FOR MICRO FINANCING STRATEGIC INITIATIVE

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ABSTRACT

Bank Financing in Indonesia is less supporting Micro & Small Medium Business sector. Some reason are the cost per transaction for the administration and the lack of financial data makes it difficult for SME to be bankable. Although Micro Business has made major contribution to the national economy. Like the percentage of the business scale of Micro Business 83.4% , Small Business15,8% . While the number of Medium and Large businesses are s less than one percent of all companies/business. Micro also contribute most to employment by 62.6%. (based on Indonesia Statistics Center Institute's data Year 2006).

Islamic economy has the same purpose as the Micro & Small Medium business in supporting the society welfare and increase employment. This paper attempts to examine the relation between Islamic Banking and Micro financing. What Islamic banking has done to support Micro financing? What type of financing scheme to increase the productivity of MSME? How this solution can be described in a business model that can be practiced in many Islamic financial institutions? These finding thus needs to be further investigated in order to provide a more detailed understanding of the issue.

Key : Islamic Banking, Micro and Small Medium Enterprise (MSME), Micro Financing, Indonesia

I. INTRODUCTION

1.1 Micro finance

Micro finance means “program that extend small loans to very poor people for self employment projects that generate income in allowing them to take care of themselves and their families” (Micro credit Summit, 1997). The World Bank has recognized micro finance program as an approach to address income inequalities and poverty. The micro finance scheme has been proven to be successful in many countries in addressing the problems of poverty. The World Bank has also declared 2005 as the year of micro finance with the aim to expand their poverty eradication campaign.

The basic principle of micro finance as succinctly expounded by Dr. Muhamad Yunus, the founder of Grameen Bank Bangladesh, and the recipient of the Nobel Peace Prize in 2006, that credit is a fundamental human right. The primary mission of micro finance is, therefore to help poor people in assisting themselves to become economically independent. Credit or loan is given for self employment and for financing additional income generating activities. The assumption of the Grameen model is that the expertise of the poor are under utilized. In addition, it is also believed that charity will not be effective in eradicating poverty as it will lead to dependency and lack of initiative among the poor. In the case of Grameen Bank of Bangladesh, women comprised of 95% of the borrowers, and they are more reliable than men in terms of repayments [Gibbons and Kassim 1990].

1.2 Micro Small & Medium Enterprise

It is evident in the way that Micro, small and medium enterprises (MSME) still exist through the era of economic crisis year 1998 & 2008, even showed a very significant growth which is evidenced by contribution of economic growth in recent years . Another country begin to look MSME in Indonesia, because of the market potential and wide segment in the country.

The government today is likely to increase and promote the economy of the people or MSME to strengthen the foundations of the economy and welfare of the community. Success or failure of such local economy is highly dependent on the ability to mobilize funds from the public and conduct business financing needs.

II. LITERATURE REVIEW

2.1 Micro Small & Medium Enterprise Definition

Micro, Small and Medium Enterprises (MSME). Ministry of Cooperatives and SME classify each group of assets and turnover criteria contained in Indonesian Law No. 20 Year 2008 on Micro, Small and Medium Enterprises (MSME) as follows:

- Micro Business, has a net worth of at most 50,000,000 (fifty million rupiahs) including land and buildings, or have annual sales turnover of many Rp300.000.000 (three hundred million rupiahs
- Small Business, has a net worth between 50,000,000 (fifty million dollars) to Rp500.000.000 (five hundred million rupiahs) including land and buildings, or having an annual sales turnover of more than Rp300.000.000(three hundred million rupiahs) to with Rp2.500.000.000 (two billion five hundred million rupiahs).
- Medium Business, has a net worth of more than Rp500.000.000 (five hundred million rupiah) until 10,000,000,000 (ten billion dollars) not including land and buildings, or has annual sales of more than Rp2.500.000.000 (two billion five hundred million rupiah) up to Rp50.000.000.000 (fifty billion dollars)

While the World Bank (World Bank) defines Micro and Small Medium Enterprise criteria as the following:

- Micro Enterprise

The number of employees less than 10 people. Income not exceeding $ 100 thousand a year. Total assets do not exceed $ 100 thousand

- Small Enterprise

The number of employees less than 30 people. Income not exceeding $ 3 million a year. Total assets do not exceed $ 3 million

- Medium Enterprise

Number of employees up to 300 people. Revenue up some $ 15 million a year. Total assets up to the amount of USD15 million.

2.2 Business Model

In recent years, the business model has attracted many attention among both academics and practitioners. While much literature, seminars panel discussions and meetings scientific discuss business models, there is no one common definition that can widely accepted by all people to enable academics and practitioners to inspect / test theories about business models through different angles.

To understand the definition of the business model, This paper will using terms of the business model defined by some academics. Giorgetti (1998) said the business model is a reference model which is a basis for a new system type which has the advantages over the older system approaches. Kraemer et al. (2000) define the business model by identifying four building blocks of the business model: direct sales, direct customer relationships to keep customer loyalty, customer segmentation for sales and service, as well as build-to-order production

Christensen (2001) define the business model as the source of all competitive advantage held by an organization that distinguishes it positioning of the companies in the industrial products. The use of generic elements to define the term business model comprehensively done by Osterwalder and Pigneur (2009). According to them, a business model describes the rationale of how organizations create, deliver and capture value held by the organization that can be described through nine elements.

9 building blocks of Business Model are :

1. Customer segment (target key customers): the consumer segment that will served the group.

It is important to determine which segments will be served by company. (most important customers) because each segment need different services, achieved by different channel distribution, requiring a different relationship, having different ability to pay and give different profit.

Types of delivery channel are :

- Mass Market (general consumers), there is no particular segment being targeted by the company. Criteria for products / services provided to all the targeted consumers.
- Niche Market, the segment of consumers who have needs / special characteristics
- Segmented, specific consumer segments that have more specific criteria. for example, by gender, age, income.

2. Value preposition (advantages offered): product and service offerings have the advantage / value which will be given to the consumer segment is both quantitative (price and efficiency) and qualitative

(consumer experience). Advantages / value offered may be either new, quality of products / services better, unique design, or brand status, lower price / competitive, ease of access and others.

3. Delivery Channel (media used to reach customer segment): Tool or media used by company to communicate to the target consumer, so the advantage / value of companies can be accepted by the target consumers.

Five stages of delivery channel are :

- Awareness : how an organization's products or services introduced
- Evaluation : how the organization helps customers to evaluate advantage / value offered
- Purchase: how a customer can buy a product or service
- Delivery : how organizations deliver excellence / more value to customers.
- After Sales : how organizations handle after-sales service.

4. Customer Relationship (How to maintain a good relationship with the customer) : How does the company / organization build relationship to target consumers.

The purpose of Customer Relationship are:

- Acquisition of new customers
- Retain existing customers
- Increase sales for existing customers

5. Revenue streams (sources of revenue): cash flow obtained by the company of each segment of its customer.

Two types of Revenue Stream:

- Transaction Revenues: Customers pay 1 (one) time.
- Recurring Revenues: Customers pay repeatedly for the services offered (value proposition) or the after-sales service.

6. Key Resources (main resources owned): important assets or resources owned by company that needed to operate. Consisting of physical assets, infrastructure, money, an intellectual human resources, culture / values that can be owned by companies or provided by key partners.

7. Key Activities (main operations performed): The main activity of the business that
should be done by the company to perform well.

8. Key Partnership (main partner): describes the relationship with third party / principal partner that is important for the business model to running smoothly.

The purpose for partnership business model include:

- Getting a cheap price due to economies of scale,
- Reduce risk (reinsurance) and add resources.
- Getting a superior resource

Type of company cooperation are:

- Strategic alliance, the cooperation with non-competitors
- Coopetition, strategic cooperation with competitors
- Joint ventures, to create new business
- Buyer-seller relationship, to ensure supply

9. Cost Structure (fee structure): describes all the types and total cost incurred to run a key activity, by using key resources and collaboration with key partners.

Some things to consider in the cost structure:

- Fixed Cost, fixed costs incurred in company.
- Variable Cost, changing costs incurred in company.
- Economy of Scale, a situation in which the output produced or acquired by the company can be 2 (two) times or more than previous output without the need of 2 (two) times cost.
- Economy of Scope, a situation where the joint output of one company is greater than the output that will be achieved by two different companies that produce the same goods. Or the conditions under which the company can produce more than 1 (one) types of goods

Policy basis to determine the fee structure:

- Cost-driven business model that seeks to minimize the cost.
- Value Driven business model that more focused on value creation, with not too concerned about the cost.

2.3 Basic principle of Islam and Islamic Micro finance

The principles of Islamic finance are laid down in Islamic law, the shariah. Islamic finance is based on the concept of a social order of brotherhood and solidarity. Islam emphasizes ethical, moral, social, and religious factors to promote equality and fairness for the good of society as a whole. Principles encouraging risk sharing, individual rights and duties, property rights, and the sanctity of contracts are all part of the Islamic code underlying the financial system.

There are a number of key Shari'a principles and prohibitions relevant to finance and commercial transactions which distinguish Islamic finance from the conventional forms. The key Shari'a principles which underpin Islamic finance, have led to the creation of a separate finance industry, are as follows: prohibition on usury and interest (riba), prohibition on realizing a gain from speculation (mayseer), no uncertainty (gharar) in commercial transactions, and, all activity must be for permitted purposes (halal).

2.4 Islamic Product Instruments of Financing

Instruments of financing may be broadly divided into (1) participatory profit loss-sharing (PLS) modes, such as, mudarabah and musharakah which are not a popular structure, however, in the context of micro finance as the thorough reporting and transparency requirements surrounding the distribution of any profit and loss can result in substantial operating burdens and costs on small enterprises unaccustomed to formal accounting. ; (2) sale-based modes, such as, murabahah; (3) lease-based modes or ijarah and (4) benevolent loans or qard with service charge :

- Musharaka (partnership)

Musharaka involves investors injecting equity into a business venture and sharing any profits and losses from that venture according to predetermined ratios. Each partner retains (though is not obliged to exercise) management rights in the venture, must receive accounting and other information on business activity, must authorize the raising of capital from any new partners and may receive a salary in return for participating.

- Mudaraba (trust financing)

Mudaraba involves an investor or investors providing funding for a business venture and a manager with fiduciary responsibilities providing managerial or market specific expertise. Investors retain ownership of the assets but have no management rights. The investor and the manager share any profits according to predetermined ratios. The investor share any losses according to their respective funding contributions.

- Murabaha (cost-plus mark-up)

Murabaha involves a finance party purchasing tangible assets from a seller and selling them to a buyer at a predetermined profit margin. In the context of trade finance, the buyer will settle the marked-up purchase price by way of immediate lump sum payment. In the context of consumer finance, the buyer will settle the marked-up purchase price by way of deferred installments. Using a tawarruq structure and an asset for which there is a highly liquid market, the buyer will settle the marked-up purchase price by way of deferred installments but will also appoint the finance party as its agent to on-sell the assets on a spot basis andremit to the buyer the proceeds of any such sale. Murabaha is the most popular and flexible Shari'a-compliant structure and is used in micro finance initiatives. However, it is costly to implement and a growing number of Shari'a scholars do not approve of it, especially in tawarruq structure, on the basis that it is merely disguised lending where the participants have no interest in actually acquiring the underlying commodities. This applies all the more in the context of providing micro finance to start-ups and small companies whose businesses do not involve the sale and purchase of commodities and which do not have sufficient surplus funds to be credibly investing in commodities.

- Ijara (sale and leaseback)

Ijara involves making available a known benefit arising from the use, possession and/or occupation of a specified asset in return for a payment. In the context of consumer financing, a finance party will purchase an asset from a client and lease it back to the client at a predetermined rate at predetermined intervals over a predetermined period of time. The finance party is responsible for maintaining and insuring the asset (though may engage another (often the client) as its servicing agent) and the asset must exist for the duration of the lease. The financier may grant the client a sale undertaking and the client grant the financier a purchase undertaking, giving the client the option to purchase the lease assets for a pre-agreed residual sum at the end of or during the lease. It is also possible to structure the lease so that the leased asset is simply transferred to the client at the end of the lease.

- Istisna (construction / manufacturing)

Istisna involves the construction or manufacture and deferred delivery of specified made to-order assets of predetermined quality and quantity in return for installment or lump sum on delivery payments. The manufacturer must procure his own goods but, unless those goods do not conform with the contracted terms, the contract is irrevocable after the commencement of manufacture.

- Salam (future delivery)

Salam involves one party making an upfront payment to another party for the future delivery of assets of predetermined quality and quantity. The contract is irrevocable after the payment of the purchase price. Although not accepted in many jurisdictions, in a parallel salam structure, the finance party will enter into a parallel but unrelated contract to on-sell the assets on delivery at a profit. However, salam is costly to implement and, in the context of forward crop-financing in agrarian societies, it covers little more than production costs and it is the financiers rather than the clients that realize any potential gains at (post harvest-season and post asset-delivery) market maturity.

- Qard Hasan

Charitable loans free of interest and profit-sharing margins, repayment by installments. A modest service charge is permissible.

2.5 Problem issue in Micro Finance

Some problems arise in Micro Financing :

- Use of non commercial product such as qard loan where only the “actual” service charge is recovered from the beneficiary, does not allow the portfolio of financing to grow while inflation is likely to erode their real value, seriously threatening their long-term survival.
- Lack of interest in microfinance is the absence of institutional credit guarantee systems in most Muslim countries. The individual borrower guarantee that is prevalent lifts the burden of loss of the business due to natural hazards, death or disability of the borrower. Nevertheless, the “portfolio” guarantee approach, whereby the guarantor covers whole or part of the default of the microfinance institution according to a specific agreement, is non-existent.
- Lack of liquidity and capital are among the perpetual problems confronting the Islamic microfinance players. The absence of any real capital market activity by Islamic microfinance providers may be due to various possible reasons, such as, the lack of awareness on the part of microfinance providers and/or lack of conducive legal and economic environment. Rating agencies that play an important role in raising of debt capital by providing indicators of default risk are also conspicuous by their absence in the Islamic microfinance sector.
- There is need and considerable scope for Islamic microfinance providers to develop new products as solutions to a variety of financial problems. However, the right approach to product development is a strategic one that takes a holistic view of microfinance as a composite product meeting the needs for financing, savingsand-investment, insurance, remittance and other services.

III. ALTERNATIVE SOLUTIONS

3.1 BPRS (Shariah Rural Bank)

is one type of bank known to serve groups of micro, small and medium enterprises with locations generally close to where people need.

According to Indonesian Law No 21 Year 2008 about Islamic Banking :

BPRS (Shariah Rural Bank) is an Islamic Banking that its activities do not provide services in payment traffic.

The business activities of the BPRS (Shariah Rural Bank) financing include:

a. collect funds from the public in the form of:

- Deposits in the form of savings or equivalent with wadi'ah contract or other agreement that does not conflict with Sharia
- Investments in the form of deposits or savings or other equivalent, according to mudharabah contract or other non-contrary to Sharia;

b. channeling funds to the community in the form of:

- Financing based on mudharabah or musharaka contract
- Financing based on murabaha, salam, or istishna contract;
- Financing based on qardh contract;
- Financing or leasing move or immovable goods to the Customer using ijarah or hire purchase contract in the form of Ijarah muntahiya bittamlik.
- Takeover debt by hawalah contract;

c. placing funds in other Islamic banks in the form of deposit using wadi'ah contract or Investment based mudaraba contract and / or any other Agreement non-contrary to Sharia;;

d. moving money, both for its own sake or for the customer's account of BPRS (Shariah Rural Bank) to the Commercial Banks Sharia, Conventional Banks, and Shariah Business Unit

e. provide products or activities of the Another Shariah Bank according to Shariah principle approve by Indonesian Central Bank.

3.2 Cooperative Banking Business Model

Based on Bank Central Indonesia (2012), Cooperative bank using cooperative principle where membership through savings. The member of these bank usually are local residents and small medium sized enterprises (SME). In some countries, Cooperative banking controlled under government supervision.

Cooperative Bank Business Model are :

1. Customer Segment

   The main customers are purely retail and small business.

2. Value Proposition

   Added value offered by Cooperative Banking is that operational based on togetherness and unity. Beside that, ease and simple credit scheme also make this banking attractive.

3. Channel

   Channel to serve the customer is using business to customer (B2C) and branch office.

4. Customer Relationship

   Cooperative Banking using personal touch approach to the customer as implementation of togetherness principal.

5. Revenue streams

   Cooperative banking revenue source are interest rate obtained from the margin, investment funds from members (retained earnings) and fee-based income for some services to its members.

6. Key Resources

   Resources for major banking cooperative banks is its members as a source of capital and as main stakeholder of cooperative banking. Economies of scale and low cost are also become the competitiveness of cooperative banking.

7. Key Activity

   Business activities held by cooperative banking are raising funds from members, channeled back the funds to members and non-members for business or consume needs.As well as providing services such as leasing, factoring, insurance and investment funds.

8. Key Partners

The main partners of cooperative banking are members and the local community where its operate.

9. Cost Structure

   The biggest cost are the cost of branch operations, staff and another resources to manage the assets and funds owned / entrusted by members for maximum benefit to members.

3.3 Islamic Products for micro-finance

Micro finance programs are based on group sharing of risk and personal guarantee while maintenance of trust and honesty is tied to the availability of future funds. This model should allow for the inclusion of a Musharaka based model, or in the least, a model of collective guarantee. MFI which look to implement Islamic finance in their programs can also develop Mudarabah based programs on the contours proposed by Atif Raza Khan in a Summer 2005 issue of Islamica Magazine. In short, MFI can find Islamic finance a natural fit in their programs – both debt and equity based.

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