The Role of Islamic Banking System as the Milestone towards Indonesia Micro Economy Development

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THE role of Islamic BANKING SYSTEM as the milestone towards INDONESIA micro ECONOMY DEVELOPMENT: a FINANCIAL REPORTS approach

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ABSTRACT

As the largest Muslim community in the world, Indonesia is optimist on implementing Islamic economy as one of the system. The previous global financial turmoil has made the attention turn on the Islamic financial model, and in particular the Islamic banking system. This model offers a microfinance system that allows poor people to meet their financial needs. Most banking systems are less concern about the difficulties affecting poor people since they usually have no collateral, making them a riskier investment. Knowing the 98.9% micro industries of Indonesia, it is an urgent need on facilitating their financial intermediaries. The Islamic microfinance system manages this demand by providing small-scale financial services to the lower and poor markets by giving them banking facility. Hence Islamic microfinance helps to sustain financial inclusion as attempt for that mostly poor society who has lack access to financial institution. The motivation for this research is to meet the knowledge gap of acceptance on the Islamic banking system implementation in the Indonesian micro economy development. The research questions is how micro industries perception and acceptance towards the existence of Islamic rural banks. The methodologies used are survey as primary data collection of 60 both Islamic and common rural banks for thorough analysis also secondary data collection from its financial reports. The research finding is the positive perception and acceptance of Islamic rural banks as micro industries' financial intermediaries. This research concludes that Islamic rural bank has become the part of micro banking services and contributes on building ideal Indonesia development.

Keywords: Islamic rural banks, development, acceptance, micro industry, financial intermediaries

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1. INTRODUCTION

1.1. RESEARCH BACKGROUND

As the largest Muslim community in the world, Indonesia is optimist on implementing Islamic economy as one of the system. The previous global financial turmoil created a chaos in both developed and developing countries. From the sub-prime mortgage crisis in United States in the late 2000s until the current European crisis, the global crisis eroded trust in conventional financial wisdom (Mirakhor and Krichene, 2008 p. 33). This has made the attention turn on the Islamic financial model, and in particular the Islamic banking system, with this alternative investment model proving more resilient in the face of the 1998 crisis. Some Islamic banks, while initially suffered, have bounced back strongly (Yudhistira, 2003).

The Islamic model offers a microfinance system that allows poor people to meet their financial needs, and its components have reduced poverty levels in Indonesia (Panjaitan-Drioadisuryo, 1999 in Morduch, 2002). The welfare for the poorest members of society is the core value of the Islamic system. Therefore the provision of cooperative banks that meet the demands of this subset of the population is of the utmost importance since with 13.3% of the population sitting below the poverty line (BPS, 2010 and CIA, 2010).

Most banking systems are less concern about the difficulties affecting poor people since they usually have no collateral, making them a riskier investment. Meanwhile, poor people usually work harder once being trusted by the institutions to manage resource. The Islamic microfinance system manages this demand by providing small-scale financial services to the lower and poor markets by giving them banking facility such as loans, saving-deposits, credit units, etc. (Siebel, 2004). Hence Islamic microfinance helps to sustain financial inclusion as attempt for that mostly poor society who has lack access to financial institution.

Indonesia consists of 98.9% micro industries, 1.01% small industries, 0.08% medium industries, and only 0.01% big industries (BPS, 2008 in Sakti, 2011). Microfinance appears as a poverty solution (Ahmed, 2004 and 2007; Chapra, 2000 and 2008; Kahf, 1999; Masyita, 2005). Even Hulme and Mosley (1996) and Montgomery (1996) mention that micro-enterprises is unlikely to help the poorest people to increase their income, this market is widely open and grow rapidly. Indonesia has over 50,000 microfinance institutions including Bank Rakyat Indonesia (BRI), the leading commercial microfinance bank (Shrader et al., 2006).

Microfinance frameworks are divided into several sectors; formal, semi formal, and informal (Siebel, 2004, p. 7). Since its creation 116 years ago, BRI has become the most successful rural microfinance institution, with more than 4000 units nationwide. Siebel (2004, p.7) also includes Bank Perkreditan Rakyat (BPR) and Bank Pembiayaan Rakyat Syariah (BPRS), known as Islamic rural bank, as the formal microfinance institution. Baitul Maal wat Tamwil (BMT) has become a semi-formal institution since some of its units are registered under Ministry of Cooperatives and Small and Medium Enterprises (Adnan et al, 2003 p.13). Without it, BMT will only be the informal microfinance institution. Informal microfinance firms are classified as unlicensed or private organizations such as usurers and individual money lenders (Adnan et al, 2003 p. 29). Siebel (2004 p. 7) believed that channelling groups and Rotating Savings and Credit Associations (ROSCAs or *arisan* in Indonesia) also fall into this category informal microfinance institution.

According to banking law in Indonesia (*Undang-Undang* No. 10 year 1998 as the amendment of *Undang-Undang* no. 7 year 1992) mention two types of bank which are commercial banks (e.g. BRI) and rural banks (BPRs). BRI and BPRs not only collect and maintain public deposit but also distributes credit to micro, small, and medium industries. One distinctive characteristic is that only commercial bank has the right to offer monetary traffic services such L/C, clearing, transfer, and collection. All deposit up to Rp2Billion in the banks is insured by the Indonesia Deposit Insurance Corporation (*Lembaga Penjamin Simpanan/LPS*). Since BMT neither under the Central Bank of Indonesia nor banking law of Republic Indonesia, BMT is not included as the banks. Without regulated by any banking regulations, all deposit in BMT cannot be insured and protected by the LPS. In another words, deposit in BMT will threat customer financial safety. Thus having legal form under the law put formal microfinance (BPR/ BPRS) safer than informal microfinance (BMT).

Nevertheless, microfinance industries should be encouraged to grow in order to achieve sounds and economy stability. Public participation including the poor people is important for socially inclusive financial system (IFSID, 2006). Microfinance is a potential tool to develop productivity of the poor to achieve sustains economic development (Comim 2007, Dowla and Barua 2006, Wright 2000, Islam 2007, in El-Komi and Croson, 2008). This research will focus on BPRS as the growing Islamic banks in Indonesia and its role in financial inclusion in order to pursue Indonesian micro economy development.

1.2. RESEARCH AIM AND OBJECTIVES

The motivation for this research is to meet the knowledge gap of acceptance on the Islamic banking system implementation in the Indonesian micro economy development. The research questions is how micro industries perception and acceptance towards the existence of Islamic rural banks. Siebel (2008) state two ways on promoting Islamic microfinance as below:

a. Encouraging Islamic commercial banks to create products with Islamic microfinance
b. Evaluate the effective performance of Islamic rural banks and cooperatives with focus on internal and external supervision and the establishment of apex associations within the institutions

Those ways allow an explanation of BPRS's development and outline an improved framework and regulatory basis for it in the future. Therefore, in line with the Ten-Year Master Plan of The Islamic Financial Services Industries, this study is urgently needed to analyse the financial inclusion as well as market acceptance and understanding on the Islamic banking system.

1.3. RESEARCH CONTRIBUTION

The contribution of this research will be twofold. An analysis of BPRS roles in the micro economy development will improve future Islamic microfinance efficiency and construct strategic improvement plan. As such, this work will contribute to the literature and lay a basis for future research.

1.4. RESEARCH PROBLEMS

This research will focus on the acceptance of BPRS (the Islamic rural bank) and BPR (the common rural bank) as the financial intermediaries. Since these are the only microfinance system could be found in Indonesia. Moreover, in any other developing countries such as Bangladesh and Pakistan that also apply microfinance; BMT and BPR/ BPRS are unique phenomena in financial institutions. Hence, there is rarely specific research in this field.

Research on BPRS over BMT is more plausible and suitable with the current economy situation aside from some burden below:

a. Apart of the Islamic microfinance components, with more than 3,874 units (Yusri, 2011), BMT has minimum regulation from Indonesian Central Bank and it is also neither monitored nor controlled by the *Badan Pengawas Pasar Modal* Indonesia (BAPEPAM -The Capital Market Supervisory Agency). However it is still subject to a relatively low level of monitoring from the Ministry of Cooperatives and Small and Medium Enterprises, regulation that is required for the legal operation of any institution. BMT is the potential future researches.
b. Such regulation, however, does not cover the mandatory regular submission of audited reports and BMT presents its reports on customer funds maintenance voluntarily. Consequently, minimum access on BMTs regular report would be occurred. Thus it would be other challenge to extract the information needed since manual data collection as field observation, direct interview, and survey should be done.

Sharia-based BPRS become the counter perspective for conventional-based BPR. These two systems, *Sharia* and conventional, urge the needs of integrated monitoring mechanism. The recent monitoring for all banking activities in Indonesia is held by Financial Services Monitoring Institution (*Otoritas Jasa Keuangan/*OJK). OJK was established as the new strict and sophisticated institution with authority to regulate, supervise, and monitor all financial services e.g. banking, investment, and non-banking institution; apart from the authority of Bank Indonesia as the Central Bank. Thus central bank could focus on its monetary and macro prudential activities; and OJK in the micro prudential activities (Setiawan, 2012).

This twin objects, BPR and BPRS, has different characteristics. The character comparability of BPR/ BPRS per December 2011 (Billion Rp) in Indonesia as below:

No	Institutions Characteristics	Bank Perkreditan Rakyat (BPR)	Bank Pembiayaan Rakyat Syariah (BPRS)
1	Financial aspects:		
	a. Assets	55, 799	3, 520
	b. ROA	3. 32%	2, 67%
	c. ROE	29. 46%	18, 95%
	d. NPL/ NPF	5. 22%	7, 05%
	e. LDR/ FDR	78. 54%	127, 71%
	f. CAR	28, 68%	23, 49%
2	Total Banks	1, 669	155
3	Total Bank Offices	4, 172	364

*NPF: Non performing Financing
*FDR: Financing to Deposit Ratio
(Source: Indonesia Banking Statistics and Islamic Banking Statistics, 2011)

Table 1. BPR/BPRS Character Comparability

With profit increase of Rp1, 7Billion or higher 21, 72% in 2011 (Suyanto, 2011), BPR significantly prove high demand of microfinance institutions from customer. This condition supported with micro small medium industries (*Usaha Mikro Kecil Menengah, UMKM*) credit growth in 2011-2012 for 16, 9% or nominal Rp421, 4Billion (SEKI, 2012). With economics supply and demand basic rules, promising growth of BPR/ BPRS as shown in the table above (define as supply of microfinance institutions proxy in Indonesia); and the credit amount of UMKM (define as demand of poor segment proxy for financial institutions support), portrays the strategic microfinance development in Indonesia.

Hence microfinance is being huge market niche to be facilitated with financial services like BPR and BPRS. However does BPRS as the financial intermediaries ready with this potential market compare with BPR? Does BPRS institutional board fundamentally different with the BPR which bring substantially new Islamic products in line with Islamic Laws? Does BPRS successfully intermediate micro industries on fulfilling their financial services? Or BPRS is not ready for being the avant-garde of formal Islamic institution financial intermediaries instead. Knowing the massive growth of Islamic microfinance as well as micro industries, particular research towards the BPRS institutional design as the preliminary knowledge on setting the strategic planning is urgently important.

1.5. RESEARCH QUESTIONS

The research questions is how micro industries perception and acceptance towards the existence of Islamic rural banks.

2. CONCEPTUAL PREMISES

In this section, I shortly review the relevant concept/facts and knowledge as well as literature review, including environmental background and BPRS definition and institutional design. This is a starting point for the study to further develop the research questions to be answered in this research.

2.2. ENVIRONMENTAL BACKGROUND

The number of rural banks still superior compared to the number of Islamic Rural Banks (BPRS) in Indonesia. In 2012 the number of rural banks in Indonesia reached 1669 banks, while the BPRS only reached 155 units. Therefore the growth and spread of BPRS is far below than BPR. In the other conditions the BPRS growth at current time is still focused on Java only. The financial performance of BPR and BPRS can be seen in total assets, Third Party Funds (DPK), credit/financing, CAR, NPL/NPF, ROA, ROA and LDR/FDR of the banks.

BPRS in Daerah Istimewa Yogyakarta or here we define as Yogyakarta has fast growth with 400% from 2006 to 2012. Among 109 conventional banks, 24 Islamic unit/windows, 11 Islamic Commercial Banks; BPRS developed from 3 units into 12 units which almost 8% of 155 total BPRS in Indonesia (Bank Indonesia, 2012 in Luhur and Rahajeng, 2012). 90,96% of Yogyakarta residents is Moslem (BPS, 2010). With further research, this market is potentially causing the high demand of implementing Islamic laws into their financial activities through BPRS.

Bank Indonesia mentioned higher national financial indicators growth by increasing BPRS total assets 28,21% from IDR2,73Trilion in 2010 into IDR3,50Trillion in 2011.

National Financial Indicators	2009	2010	2011
Total Assets (Trillion IDR)	2,12	2, 73	3,50
Third Party Fund (DPK) (Trillion IDR)	1,25	1,60	2,09
Islamic Banking Financing (Trillion IDR)	1,58	2,06	2,67
CAR (%)	30,00	27,50	23,50
NPFs Gross (%)	8,12	6,50	6,11
NPFs Net (%)	6,65	5,36	5,14
ROA (%)	3,50	3,50	2,70
BOPO (%)	77,00	78,10	76,30
FDR (%)	126,47	128,47	127,71

Table 2. National Financial Indocators
Source: Bank Indonesia Central Bank (2011)

As classified in the Bank Indonesia, BPRS has FDR 118.61%, higher than the FDR *Sharia* Commercial Bank of 71.25%. Meanwhile, the financing quality of Islamic banking as reflected in the ratio of Non-Performing Financing (NPF) has decreased from 3.96% (December 2010) into 3.69% (March 2011).

2.3. BPRS DEFINITION AND INSTITUTIONAL DESIGN

Based on the Law of the Republic of Indonesia Number 7 of 1992 about Banking as amended by Act - Act No. 10 of 1998, Article 1 stated that the term "Bank is a business entity which collects funds from the public in the form of deposits and distribute it to the community in the form of credit and or others to improve the lives of the common people.

BPRS as one of the Islamic banks are allowed to operate with a system of

Sharia in Indonesia. In the national banking system, BPRS is established to serve the Micro and Small Enterprises (SMEs). Bank Indonesia stated that Islamic rural bank (BPRS) has plenty activities as such collecting fund from people by saving products/deposit through *wadi'ah* contract, distributed public funds trough Islamic financing for instance *salam*, *mudharabah, musyarakah, murabahah, istishna, qardh,* and *ijarah*; and other financial services like taking over loan through *hawala*h contract. All the transaction should obey the Islamic Law and hold Bank Indonesia Central Bank approval. BPRS also facilitate their customer with other Islamic and/or conventional banks unless foreign exchange, clearing, and giro.

No	Province	Number of BPRS
1	Jawa Barat	27
2	Banten	8
3	DKI Jakarta	2
4	Jawa Tengah	21
5	Jawa Timur	30
6	DI Yogyakarta	11
7	Bengkulu	2
8	Jambi	0
9	Nanggroe Aceh Darussalam	10
10	Sumatera Utara	10
11	Sumatera Barat	7
12	Riau	4
13	Sumatera Selatan	1
14	Bangka Belitung	1
15	Kepulauan Riau	1
16	Lampung	6
17	Kalimantan Selatan	1
18	Kalimantan Tengah	0
19	Kalimantan Barat	0
20	Kalimantan Timur	1
21	Sulawesi Tengah	0
22	Sulawesi Selatan	7
23	Sulawesi Utara	0
24	Gorontalo	0
25	Sulawesi Barat	0
26	Sulawesi Tenggara	0
27	Nusa Tenggara Barat	3
28	Bali	1
29	Nusa Tenggara Timur	0
30	Maluku	0
31	Papua	1
32	Irian Jaya Barat	0
33	Maluku Utara	0
	Total	155

Table 3. BPRS Distribution in Indonesia

2.4. FINANCIAL INCLUSION

Financial inclusion defines as the affordable and reachable financial intermediary's services towards micro and medium enterprises/sectors/industries. Many economy sectors as mentioned previously have minimum access into banking and financial services due to lack of collateral as well as administrational requirements. Most of micro industries are financial illiteracy with minimum knowledge and understanding on having structured financial reports that disadvantage them in the financial intermediary's process. Banks and financial institutions need reliable industries before making any transaction/contracts such as loan, credit, and other financial supports. In the other hand, micro industries in particular lack of educated and financial skilled human resources. Their ability is limited on specific skills such as production, selling, and other services.

Therefore it's urgently needs the financial inclusion to attract non-bankable industries into formal financial intermediaries. The need on transforming those micro industries which mostly informal sectors into formal sectors is securing industries stability financially and organisationally. Micro industries have to have orderly financial reports that urge them to improve their skills to meet the minimum banking standard.

Financial inclusion also defines as facilitating who has more funds and who needs additional fund to develop their enterprise and/or industries. Sharma (2010) mentioned that financial inclusion as a process that ensures the ease of access, availability and usage of the formal financial system for all constituent of an economy. These views seem in line with Kamath (2007) and Dev (2006) who defined financial inclusion as the process of ensuring access to timely and adequate credit and financial services by vulnerable groups at an affordable cost. Moreover Chibba (2009) supports the definition that financial inclusion is very potential in reducing poverty, promoting pro-poor growth, and addressing the Millennium Development Goals (MDGs).

3. RESEARCH METHODS

The methodologies used are survey as primary data collection of 60 both Islamic and common rural banks for thorough analysis also secondary data collection from its financial reports distributed from 2008 to 2012.

In the first stage, explanatory research focused on the 60 listed the BPR and BPRS in Indonesia which mostly in Java Island. All financial aspects namely the ratios (CDR, ROE, ROA, BOPO, FDR, ROE, Assets to Loan Ratio, Capital to Debt Ratio, Gross Profit Margin, Net Profit Margin, etc), total asset, total liabilities, total financing, total third parties fund (*Dana Pihak Ketiga – DPK*). This research will purposively choose one BPRS which meet the sufficient bank size. This first stage is using secondary data from the banks website.

Secondly, the in-depth interview was addressed to get the selected BPRS non financial information namely organisational information (branch numbers, employee number, and customer numbers together with the background) and other data needed which could not be found from banks' websites or from previous secondary data collection. Preliminary research on BPR/BPRS that includes internal control mechanism, external supervision, and establishment of associatory with apex services which will cover the rules and regulation compliance, product types, human resource management (IFSID, 2006); will improve the industries understanding.

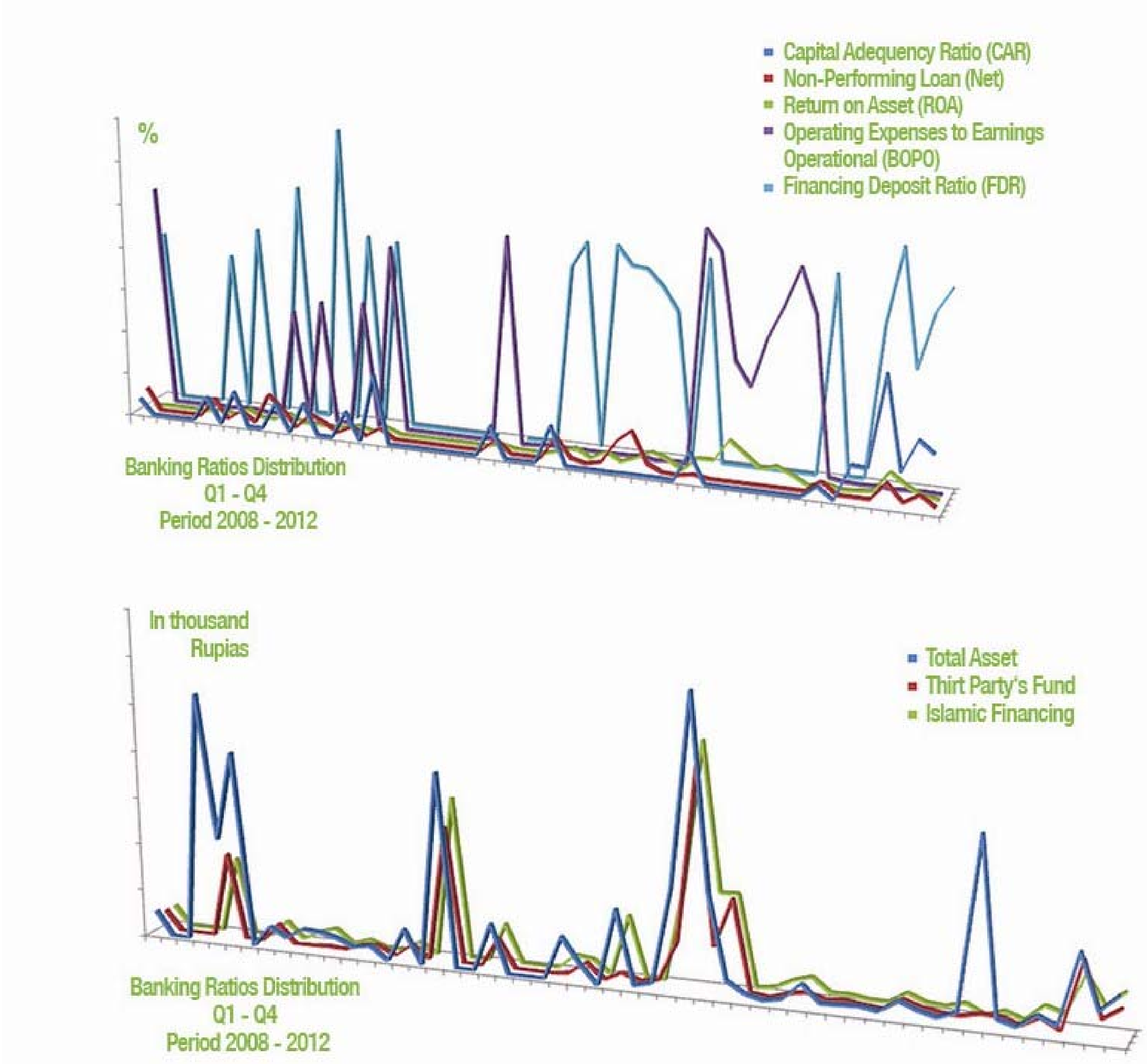
4. RESULTS AND DISCUSSION

The research finding is the positive perception and acceptance of Islamic rural banks as micro industries' financial intermediaries. As the research conducted in two stages, financial reports approach and in-depth interview that conducted in 60 BPR/BPRS in Indonesia. There are plenty obstacles during data collection such as limited data access, minimum understandability toward research purposes that cause research reluctant, limited financial reports knowledge, and limited field access. The in-depth interview conducted to BPR/BPRS market and potential costumer.

The results are presented in both financial ratios analysis and public perception summary as below:

4.1. FINANCIAL RATIOS

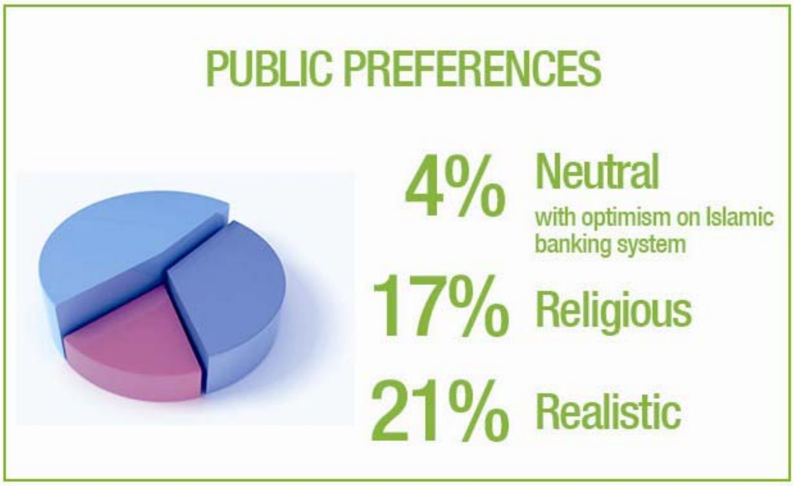
Financial reports analysis extracts financial ratios from 60 BPR/BPRS. The financial ratios are summaries into 9 categories namely Total Assets (Rp), Third Party Funds (*Dana Pihak Ketiga*-DPK) (Rp), Islamic banking financing (Rp), Capital Adequacy Ratio (CAR) (%), Non-Performing Financing (NPFs) Gross (%), Non-Performing Financing (NPFs) Net (%), Return on Assets (ROA) (%), Operating Cost per Revenue Cost Ratio (*Biaya Operasional Pendapatan Operasional* – BOPO) (%), Financial Deposit Ratio (FDR) (%). The summary of each financial ratio for 60 BPR/BPRS (in aggregate) as shown below:



The ratios portray increasing trend that inferred the acceptance of BPRS' products and services among the society. These ratios are not comparably absolute with BPR considering character differences. BPR has many advantages in financial market compared to BPRS. The early existences of BPR make BPR more stable financially and bigger market share than BPRS which grow lately. However BPRS show minimum barrier on entering BPR market. BPRS develop rapidly that represent from its developing financial ratios. Despite of special condition that occurred during the BPRS developing process in particular BPRS in several areas, market/society has positive acceptance and potential financial interest on utilise it as their financial intermediaries.

4.2. IN-DEPTH INTERVIEWS

The interview conducted with two main questions of customer perception and preferences on BPR/BPRS by using several consideration factors namely financial, product variety, corporate governance, access, security, etc. These factors are improved to get thorough costumer consideration in order to get assurance on preference making. The results are presented below:



The result portrays public preference on BPR/BPRS. There are no absolute preferences for both financial services since costumers are distributed into two groups of preference. The first group is classified as the religion group which their preference is based on religiosity consideration. They prefer BPRS to BPR due to ultimate religiosity matters which affect on life serenity for following religion conduct. By choosing BPRS they feel more religious secure for both products and services given. Thus they put aside the existence of BPRS than BPR in banking development. The second group is classified as the realistic group which considering and compares all financial decision making factors for both BPR and BPRS. The ease process, low interest or high margin of profit sharing ratio, location access are some consideration factors for this group, without any religion consideration. The decision concluded by using benefit analysis.

While costumer has optimism that BPRS will show better performances in the following period considering their fasts grow. Thus this optimism inferred the positive perception and acceptance towards Islamic rural banks in the society.

5. CONCLUSION

This chapter brings together the findings from the data analysis result and answers which confirms the answer of the research questions regarding the perception and acceptance of BPR/BPRS representing rural banks and Islamic rural bank.

This research conducted in 60 BPR/BPRS as the representation of rural banks and Islamic rural banks development in Indonesia. Both financial ratios analysis and in-depth interview shows the positive perception and acceptance of BPRS as their financial intermediaries as well as BPR as the previous player in banking industries. Islamic rural banks, known as BPRS, are welcome as the new alternative in banking industries particularly on micro industries sectors. With the optimism and acceptance towards BPRS, thus micro enterprise/industries will have financial and banking access to support their industries.

This research concludes that Islamic rural bank has become the part of micro banking services and contributes on building ideal Indonesia development.

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