

The Profile of Micro, Small, and Medium Enterprises in Indonesia and the Strategy to Enhance Islamic Financial Services through Baitul Maal wa Tamwiel

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ABSTRACT

There are more than 44 million micro, small, and medium enterprises (MSMEs) in Indonesia which cover 99.9% off all businesses, but only 22.14 % of them that enjoy financing facilities from banks and other micro or non-bank financial institutions. Out of those MSMEs, 40 million of them are micro enterprises in rural area, and only 5 million of them can have access to bank's financing, because of legal formal limitations. One type of Islamic micro non-bank financial institution is Baitul Maal wa Tamwiel (BMT). By the end of 2006 there are about 3,400 BMTs with total assets of more than Rp.2.2 trillion. Moreover, based on BMT Architecture of development, the number is expected to grow to 10,000 BMTs in 2010. BMTs can be empowered, supported, and financed to act as development agent to enhance Islamic financial services to these unreached micro enterprises to reduce unemployment and improve the welfare of low income society. Several channeling programs from the government through Islamic Banks and BMTs have been developed and proposed to improve intermediation to micro and small enterprises. Moreover, several modes of financing, such as *mudharabah muqayyadah*, *mudharabah wal murabahah*, and *musharakah wal murabahah*, can be applied to these channeling programs. To better serve MSMEs, Islamic banks should focus to serve medium enterprises, rural Islamic banks should focus to serve small enterprises, while BMTs should focus to serve micro enterprises. The government can provide some incentives for these strategies to be working effectively.

JEL Classification: G23, G28

Keywords: Micro Business, Baitul Maal wa Tamwiel, Micro Finance, Channeling

1. Introduction

1.1 Background

Since Indonesia hit by the financial crisis in 1997, the growth of banking loan expansion has shown a declining trend. The industry's loan to deposit ratio (LDR) has never reached 70% since (except for Islamic banks that have financing to deposit ratio or FDR of 111%). This figure is not even close to the LDR figure before the crisis that reached more than 100%. This low LDR due to several factors, such as, the trauma of the past crisis that caused non performing loan jumped to almost 50%. Therefore, banks tend to be more prudent in extending loan to business sector. It becomes even worse with the uncertainty of politic and economic conditions, as well as unclear economic policy direction. Moreover, more prudent banking regulation to prevent the next crisis is also make banks behave this way. Therefore, banks' loan portfolio are more directed toward consumer loans, such as, home loan, car loan, credit card loan, multi purpose loan, etc. The rests are mostly invested in central bank certificates (SBI). After the crisis, the growth of SBI has always been increasing at around 45% per year, on average, while the growth of loan extension increased by only 25%.

Some lessons learnt from the crisis stated by Tambunan (2004), among others, are 1) Indonesian economy can not rely only to the role of large enterprises; 2) MSMEs have better crisis survival ability than large enterprises, since they are believed to be more efficient; and 3) Until this time, there is no clear industrial policy and strategy yet to accelerate economic growth and employment to reduce unemployment and to eradicate poverty. Meanwhile, the role of micro, small, and medium enterprises (MSMEs) after the financial crisis of 1997 can be viewed as a safety valve in the process of national economic recovery, not only to stimulate economic growth, but also to reduce unemployment. The 2005 data shows that almost all businesses in Indonesia take the form of MSMEs, which absorb 96.77% of employment, especially micro and small enterprises (MSEs).

Table 1.1 Profile MSMEs (2005)

	Number		GDP	Labor		Export
Small*	44,621,823	99.84%	39.36%	71,187,153	88.69%	3.75%
Medium	67,765	0.15%	17.12%	6,491,345	8.09%	11.01%
Large	4,171	0.01%	43.53%	2,590,275	3.23%	85.24%
MSMEs	44,689,588	99.99%	56.48%	77,678,498	96.77%	14.76%

Source: Ministry of Cooperative and SMEs, 2005. Yearly Revenues Small: < Rp1 bn; Medium Rp1 bn – Rp5 bn; Large: > Rp5 bn. *Including micro enterprises.

Ironically, the amount of loan extended to MSMEs from formal financial institutions, i.e. banks, is very small compare to the loan extended by banks to big enterprises. Moreover, in 2002 – 2005, the portion of loan extended to MSMEs has been stagnant. There are more than 44 million MSMEs in Indonesia, but only 22.14 % of them that enjoy loan facilities from banks and other micro or non-bank financial institutions. Moreover, out of those MSMEs, 40 million of them are micro enterprises in rural area, and only 5 million of them can have access to bank's financing (Republika, December 9, 2006, p.19).

The above conditions show that banking intermediation is not well functioning, especially the intermediation to MSEs, and there still exists a big problem faced by MSEs. On the other hand, however, these conditions also show that there is a big potential of credit expansion, since the market for micro financing is still very much open.

Basically, the source of fund for corporation can be obtained from bank or non-bank financial institution (NBFI), or from own capital. Capital market as a big source of funding has not been fully utilized by business sector in Indonesia, not to mention MSMEs. The existing rules and regulations, as well as requirements sometimes prevent the corporation to enter the capital market. Only big corporations that really can absorb fund from capital market, while MSMEs still not able to absorb fund from capital market. More over, MSMEs can only have limited access to bank's loan, especially for medium enterprises. Therefore, most MSEs usually only have one alternative source of fund, namely micro NBFI¹.

In Indonesia, there are several types of micro NBFIs that focus on extending loan to MSMEs, such as, venture capital, co-operation, local micro NBFI (such as, lumbung nagari in West Sumatera), rural micro NBFI (such as, rural co-operation), and others. One type of micro NBFI that rapidly growing is Islamic micro NBFI called Baitul Maal wa Tamwiel (BMT). By the end of 2006 there are about 3,400 BMTs with total assets of more than Rp.2.2 trillion. Moreover, based on BMT Architecture of development, the number is expected to grow to 10,000 BMTs in 2010.

In Indonesia, most businesses are in the form of MSMEs that cover 99% of all businesses. They have a big potential not only for employment, but also for their contribution to economic strength and development. However, banks are reluctant to extend loan to them due to several reasons. For example, administration and supervision costs of one small business with small loan are similar to one big business with huge amount of loan. This means that extending loan to MSMEs are more costly, hence less profitable. Therefore, banks prefer to extend loan to big businesses that more cost efficient and more profitable.

Several previous studies show that the main reason why MSMEs can not obtain bank's loan is because they have legal formal limitations to access banks, not because of interest rates. Many MSMEs, especially micro enterprises, have to go to individual money lenders with high interest rate to get loans for financing their businesses. However, they can manage to repay the loan.

With this background condition, to reduce unemployment and improve the welfare of low income society, the development, enhancement, and empowerment of 40 millions micro enterprises are an urgent priority. The role of Islamic micro non-bank financial institutions, like BMTs, become even more important to fill the gap that can not be served by banking institutions to provide and channel financing facilities to these unreached micro enterprises.

1.2 Objectives

Based on the above background, the objectives of this study are: 1) to explain the profile of micro, small, and medium enterprises in Indonesia and present comprehensive picture based on survey done by Bank Indonesia in 2005; and 2) to design strategy to enhance Islamic financial services, especially for micro enterprises through Baitul Maal wa Tamwiel.

1.3 Data and Methodology

This study will apply qualitative and exploratory approaches using secondary data obtained from several sources, such as Ministry of Cooperative and Small and Medium Enterprises, Bank Indonesia, Center of Statistics Bureau, Ministry of Finance, and other related sources. This study will also apply descriptive study through literature studies from text books,

¹ One exception is Islamic banking that extends more financing to MSMEs. The financing portfolio of Islamic banking shows 71.84% of MSMEs loan and 28.16% of non MSMEs loan in October 2006.

journals, papers, and other publications. The results of survey conducted by Bank Indonesia will also become the main source of analysis.

2. The Profile of MSMEs in Indonesia

Micro, Small, and Medium Enterprises (MSMEs) in Indonesia have been long believed to be the main pillar of Indonesian Economy. This fact is supported by the huge number of enterprises across almost all economic sectors, the labor intensive production modes, and the significant contribution to the gross domestic products (GDP). To improve the role of MSMEs in accelerating economic growth, the profile of MSMEs in the main economic sectors should be identified to provide detailed picture of characteristics, potentials, and problems faced by MSMEs, including managerial, legal, financial, production, human resource, marketing, and business expansion aspects. This profile is very important to identify problems, to formulate policy recommendations, to set MSMEs development priorities. The results of MSMEs survey conducted by Bank Indonesia in 2005 will be presented in this chapter.

2.1 Respondents Profile

There are three groups of respondents, namely 1) MSMEs, totaling 11,000 units from 4 economic sectors (agriculture, trade, industry, and services), conventional and Islamic banks customers (33.4%) and non customers (66.6%), in 11 provinces; 2) Banks, totaling 140 Conventional and Islamic banks, main and branch offices, including rural banks; and 3) Government and Association, totaling 137 institutions.

Based on yearly revenue, the MSMEs respondents comprise of 32.7% micro, 49.4% small, and 17.9% medium enterprises, which come from agriculture (12.2%), trade (34.4%), industry (24.6%), and services (23.4%). Most of MSMEs (83.5%) are informal (personal) businesses that do not have formal legal form. Moreover, most of the entrepreneurs are men (81.2%) with the education level of high school (44.1%), undergraduate (17.9%), and 3-year diploma (7.4%).

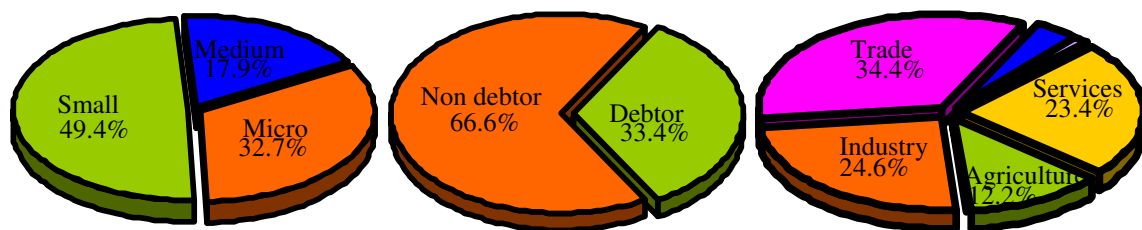


Figure 2.1 Respondents Profile

Respondent profiles across regional area do not show any significant differences. However, there are some regions that show strength in certain aspect. Most MSMEs involve in trade sector, while hotel and restaurant are prevalent (51.7%) in North Sulawesi. Moreover, MSMEs in industry sector are prevalent (41.5%) in West Java and agriculture sector is not dominant in any region.

2.2 Results

The results of the survey will be presented, which include managerial aspect, legal aspect, financial, financing and capital aspects, production aspect, marketing aspect, human resource aspect, and business development aspect.

2.2.1 Managerial Aspect

Most of MSMEs operators have been involved in the similar field before. The main motivation of respondents to enter into MSMEs is to become self sufficient entrepreneurs (79.6%), while the main reason they choose their current business is that because they already have the skills and experiences (49.2%). This satisfying fact shows that generally they have entrepreneurship minds. Their businesses mostly provide main incomes for their families.

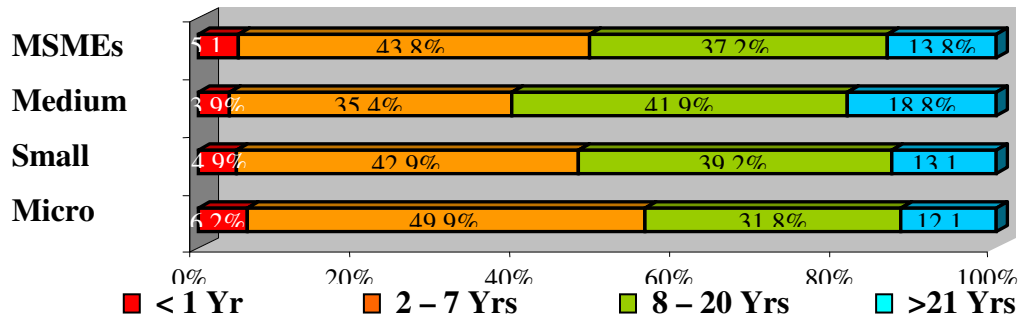


Figure 2.2 Length of Business

Viewed from the length of business they hold, unlike the majority perception, MSMEs entrepreneurs are not 'hit and run' entrepreneurs that can easily shift from one business to another. The survey shows that most MSMEs (51%) have run the business for more than 7 years, while 13.8% of them have run the business for more than 21 years. This fact shows that MSMEs are sustainable businesses in the long run.

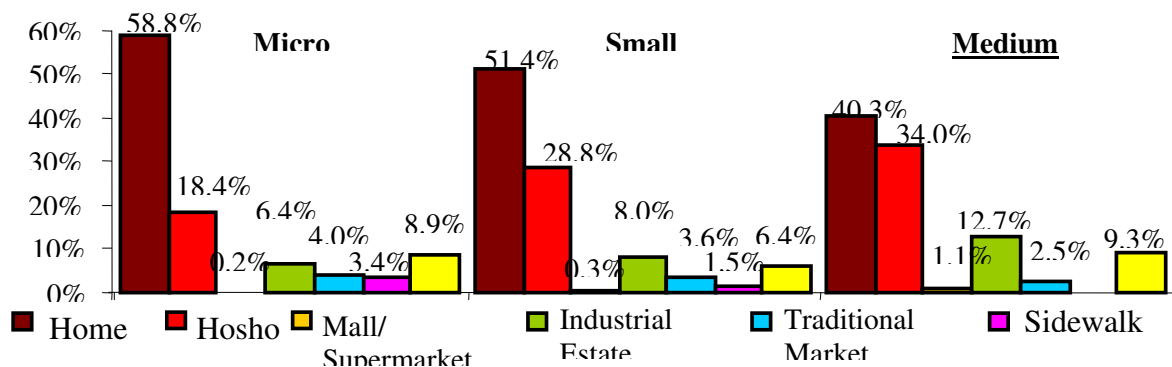


Figure 2.3 Place of Business

Most MSMEs are personally owned and managed by them selves. Most MSMEs choose home as their place of business, followed by home-shop and industrial estate. Only small part of them chooses traditional market or mall and supermarket as their place of business. Moreover, most of them do not have formal organization structure. Micro and small enterprises established after the financial crisis (2-7 years old) mostly are situated in East Kalimantan (71.4% and 58.6%, respectively). Meanwhile, micro and small enterprises older than 7 years mostly are in Bali (52.1% and 60.3%, respectively). Moreover, most medium enterprises older than 7 years are in West Java (74.8%).

2.2.2 Legal Aspect

Most MSMEs are not in the form of formal legal institutions, especially micro enterprises (98.6%). MSMEs in transportation and communication sectors usually already have legal form. In term of business permits, the larger the business the more formal the structure of MSMEs. Therefore, there is only small number of micro enterprises (around 20%) that holds business permit (TDI/TDP and SIUP) and NPWP, while most medium enterprises (more than 80%) holds necessary business permits. Moreover, around 50% of small enterprises hold business permits. MSMEs that hold business permit, most of them do not need an agency to process their permits that take less than one month (for TDI/TDP and SIUP) and less than two weeks (for NPWP). The costs, procedures, and administration requirements are not constrained them to get these business permits. The main reasons for MSMEs to obtain these various business permits are to fulfill government regulations and to fulfill loan application. Almost 50% of micro enterprises view that business permits are constrained them, while more than 50% of micro enterprises view financial statements are still constrained them.

The fact that only small numbers of micro and small enterprises that already hold some kind of business permits show that the government need to give incentives for those MSMEs that already hold the permit so that they recognize the benefits of holding business permits. Moreover, it is necessary for the government to relax the requirements, to simplify the process, and to abolish informal/hidden costs in the process of obtaining business permits.

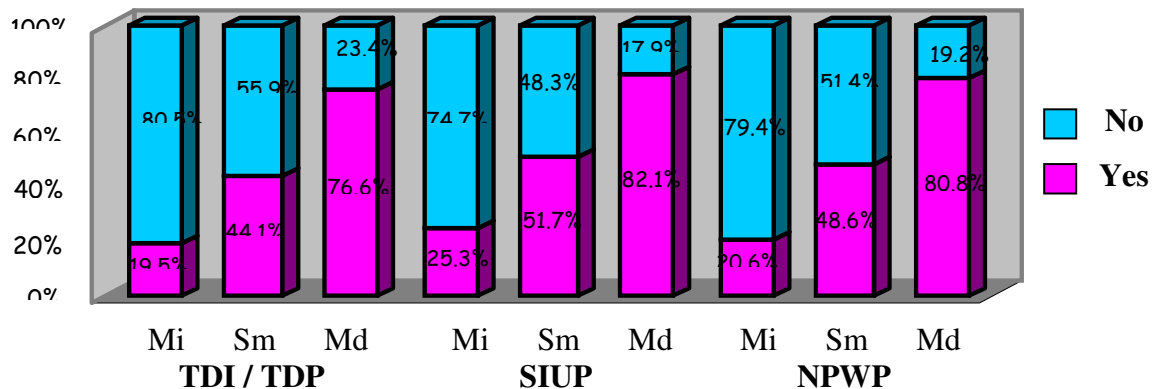


Figure 2.4 Business Permits Ownerships

Most MSMEs do not have legal form, yet. But, most MSMEs in the form of limited company are resided in Jabodetabek (7.7%) and most MSMEs in the form of public company are located in East Kalimantan (2.5%). Moreover, MSMEs that already have business permits are located in Bali.

2.2.3 Financial Aspect

Most micro enterprises own assets (excluding land and building) of less than Rp100 million (US\$11,000) with the mean of Rp50 million (US\$5,500), while most of small enterprises own assets (excluding land and building) of less than Rp200 million (US\$22,000) with the mean of Rp189 million (US\$20,770). Moreover, most medium enterprises own assets (excluding land and building) between Rp1 billion (US\$111,000) and Rp5 billion (US\$555,000), with the mean of Rp3 billion (US\$333,000). From banking standpoint, the asset of each scale of enterprise should be higher. For example, micro enterprises assets should ranged from Rp119 million (US\$13,000) to Rp369 million (US\$40,550). Therefore, there is a business scale gap between the reality and the expected by the banking sector, so that the banking sector should lower their expectation to reduce the gap with the real financial condition of MSMEs. Working capital mean of micro enterprises is Rp85 million, small enterprises is Rp514 million, and medium enterprises is Rp2 billion, which come from own

capital 71% and 66.9% and family and friend 29% and 33.1%, for micro and small enterprises, respectively.

Table 2.1 MSMEs Financial Profile (Rp million)

	ASSET*	WORKING CAPITAL	YEARLY REVENUE	CREDIT LIMIT**	LABOR
Micro	50	85	< 50	<50	3.6
Small	189	514	101-250	50 – 500	16.6
Medium	3,000	2,000	1,000-5,000	500 – 5,000	38.2

US\$1 = Rp9,100; * Asset excluding land and building; ** Bank Indonesia Regulation

Micro enterprises with the largest average asset is located in Bali (Rp152 million) and the smallest is located in Java (Rp18.2 million). Similarly, small enterprises with the largest average asset is also located in Bali (Rp292.8 million) and the smallest is located in North Sumatera (Rp92.7 million). Moreover, the largest average asset of medium enterprises is located in East Kalimantan (Rp7.12 billion) and the smallest is located in North Sumatera (Rp1.32 billion).

The yearly revenues of most micro enterprises are less or equal to Rp50 million, small enterprises are between Rp101 million to Rp250 million, and medium enterprises are between Rp1 billion to Rp5 billion. Even though the revenues of micro and small enterprises are relatively small, they enjoy greater profit margins between 10% and 50%, while the profit margins of medium enterprises are less than 10%. These facts are inline with the mythos that micro and small businesses can get high profit margins. With high profit margins MSMEs should not have any difficulty to pay loans at market interest rate, so that they do not really need financial support in terms of interest rate subsidy. While from banking perspective, even though MSMEs earn high profit margins, they lack financial management, so that it is necessary for bank and MSMEs mentor to assist MSMEs in managing their financial in order to maintain the sustainability of their profits.

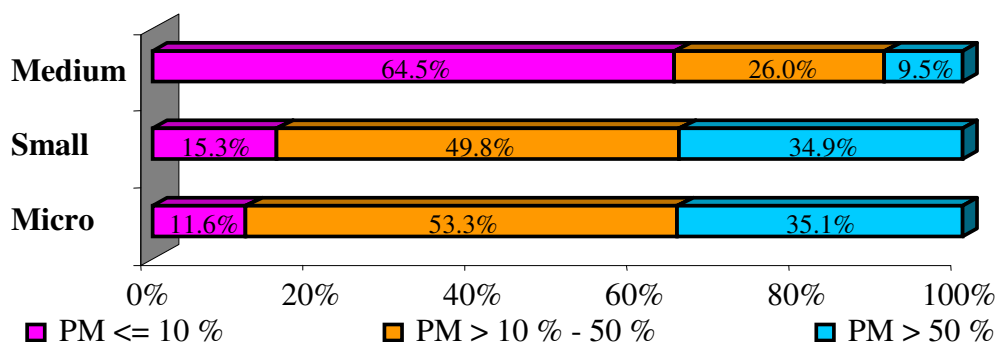


Figure 2.5 Profit Margins of MSMEs

The most micro enterprises with average revenue less than Rp50 million is located in West Sumatera (94.4%), small enterprises with average revenues between Rp101 million and Rp250 million is located in Bali (35.1%), and medium enterprises with average revenue between Rp1 billion and Rp5 billion is located in West Sumatera (83.1%). Moreover, the most micro enterprises with profit margins between 10% and 50% is located in Riau (84.6%), and those with profit margins over 50% is located in South Sulawesi (61.5%). Meanwhile, the most small enterprises with profit margin between 10% and 50% is located in East Kalimantan (73.3%), and those with profit margins over 50% is located in West Sumatera (55.2%). Whereas, most medium enterprises only earn profit margin of less than 10%, and most of them is located in West Java (58.3%).

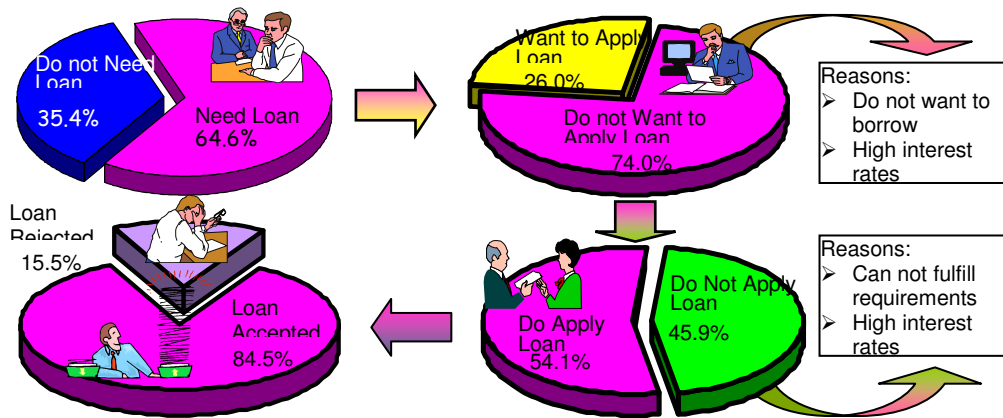


Figure 2.6 Financing Need, Application, and Realization

Almost all micro and small enterprises, and all medium enterprises utilize banking products and services, especially deposits, loans, and ATM. The main reason to choose bank is the safety. Although most MSMEs state that they need financing, but not all of them try to apply, due to inability to provide collateral (micro) and high interest rates (small and medium). While from banking perspective, the main problem of MSMEs in loan application is the feasibility of the business in terms of financial, marketing, as well as human resource. Of those MSMEs already submit their loan applications, most of them are accepted (84.5%). Moreover, most micro and small enterprises believe that banking does not extend enough financing to them, while medium enterprises believe that banking does extend enough financing to fulfill their financial needs.

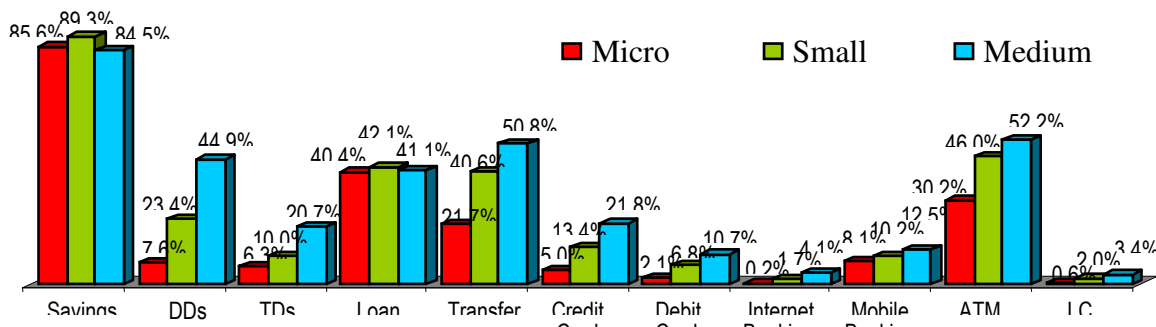


Figure 2.7 Utilization of Banking Products and Services

The main source of MSMEs capital is their own capital, and additional capital (if bank loan is not enough) comes from families and friends, so that it is clear that capital needs of MSMEs are mostly depend on sources other than bank. Therefore, there is an opportunity and challenge for banking to provide loan to fulfill capital demand of MSMEs.

Most MSMEs operated with own capital is located in West Java, while most MSMEs utilizing bank loan is located in Bali. Similarly, most MSMEs utilizing bank's products and services is located in Bali. Moreover, most MSMEs submit credit application and has enjoyed bank loan is located in North Sulawesi.

2.2.4 Production Aspect

The raw material supplier of micro and small enterprises mostly comes from other MSMEs in the same municipality area, while for medium enterprises mostly comes from other MSMEs in the same province area. Most MSMEs consider raw material supply is not a problem, but the cost of raw material dominates the production cost. The high cost of raw material is

believed because of long distribution channels, informal retributions, and the increase of oil price.

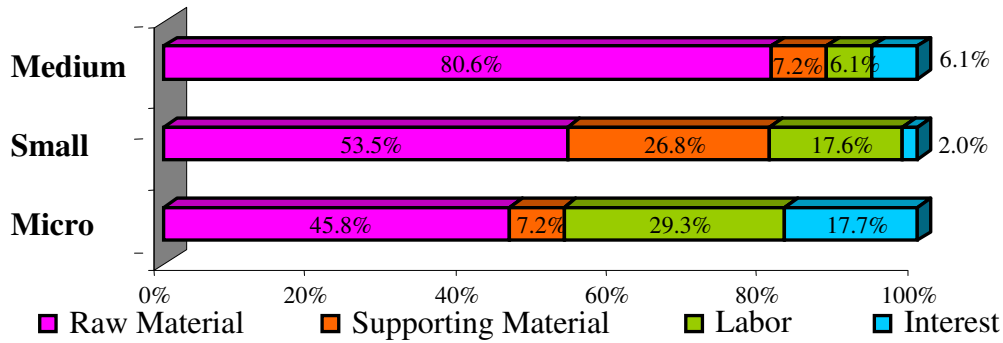


Figure 2.8 Production Costs Structure

The survey shows that the majority of micro businesses apply manual production process (59.5%), while small (58.6%) and medium (69.2%) enterprises apply semi-automatic production process. Quality control of production has been applied by most MSMEs, manually, while production capacity utilization has reached 80%, and increasing, so that most MSMEs increase their production capacity.

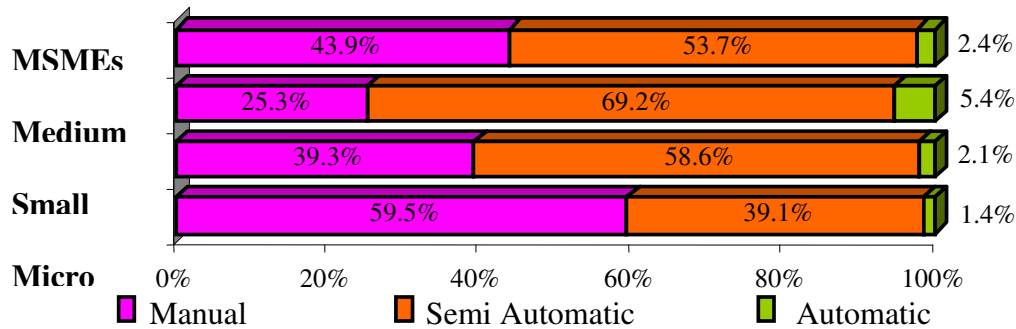


Figure 2.9 Mode of Production

2.2.5 Labor Aspect

The survey shows that average number of labor in micro business is 3.6 persons, small business is 16.6 persons, and medium business is 38.2 persons. The most labor intensive sectors are industry and trade. Education level of labor is mostly high school (39.4%), junior high school (24.4%), and elementary school (21.6%). Only 9.5% of them hold diploma or higher education. Most MSMEs labor (72.1%) are in their productive age (15-45 years), while the rest are older than 45 years.

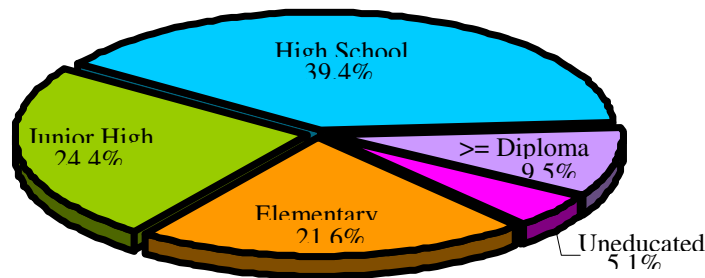


Figure 2.10 Labor Education

Both, the owner and the labor of MSMEs have not received any kind of training, yet. Consequently, most MSMEs labor only possess low skill level. The survey indicates that both MSMEs and bank consider skills and experience as the main problem of MSMEs labor. The improvement of labor skills is our responsibilities, especially related government institutions that should improve the quantity and quality of training, including the revival of the dormant workshop centers (balai latihan kerja). Most entrepreneurs that have received training are located in West Sumatera, while most labor forces that have received training are located in Bali. The most frequent training is skill/technology training related to business area.

2.2.6 Marketing Aspect

Most MSMEs conduct direct marketing to their customers through retail/individual sales and through distributor. The main marketing destination area of MSMEs is mostly local market, within the same township, municipality, or city. Only small part of their market is oriented toward export. The main export market of MSMEs is Asean and East Asia (Japan, China, and South Korea). The dominant marketing strategy is service improvement, product quality improvement, and price discount. Market competition of MSMEs is relatively high, especially in trade sector. However, their sales are generally sound, with only minor problem due to price competition and market information.

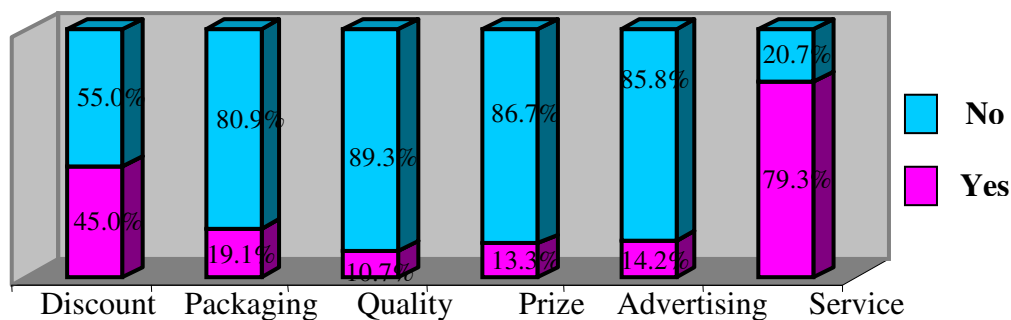


Figure 2.11 Marketing Strategy

There is only small portion of MSMEs (22.4%) stated that they really need marketing assistance, in terms of market access to routine/fixed corporations, marketing coordination by the government, and market information. Moreover, there is only small portion of MSMEs that join business associations (16.8%) and cooperative (11.2%).

Survey shows that only 6.9% of micro and small enterprises which are subsidiaries of business groups. Moreover, there are only 34.9% of MSMEs that have partnership relation with other business, especially as supplier (42.8%).

2.2.7 Business Development Aspect

In relation to government policy of MSMEs development, there is only 14.1% of MSMEs that have received support / facility from the government, especially in terms of credit facility, management training and workshop. Most MSMEs expect credit facility. This fact shows stigma of government support that is always associated with credit facility, so that government supports should also give attention to other aspects of MSMEs that need improvements, since MSMEs are highly profitable and prospective businesses.

MSMEs view that future business prospect is promising, especially in individual/ household services, trade, hotel and restaurant, and agriculture sectors. The majority of MSMEs will continue and expand their businesses in the next year by capital increase, market expansion, and production capacity improvement. In the next 3-5 years, medium enterprises plan to

invest in land, transportation means, and machinery. This investment plans show that medium enterprises are optimistic about their sustainability and business expansion.

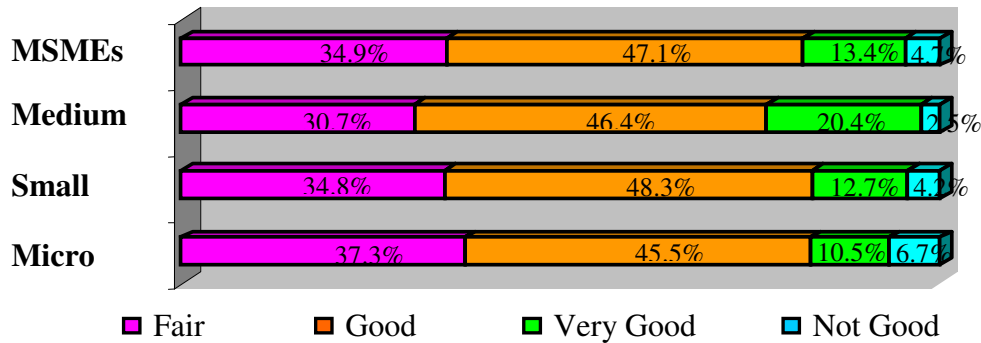


Figure 2.12 Future Business Prospects

Moreover, most MSMEs put capital increase as their priority for the next year business development planning, followed by market expansion and space expansion. Skill improvement and productivity improvement are their subsequent priorities for their development plan.

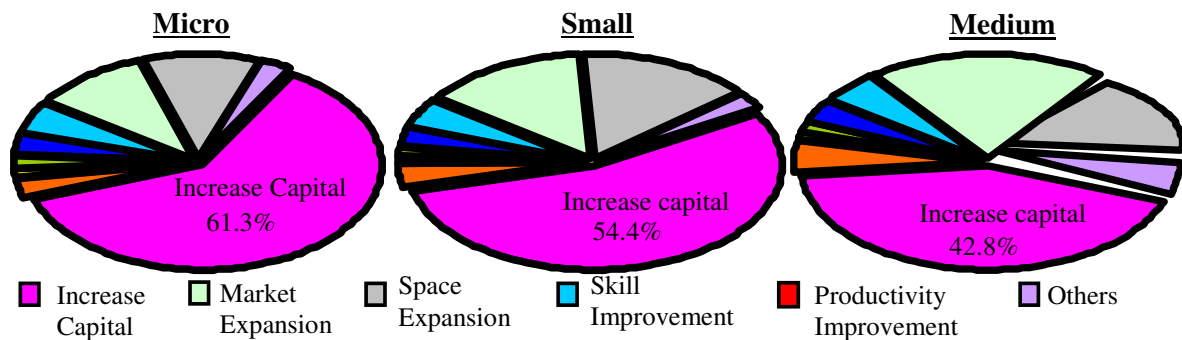


Figure 2.13 Future Business Plan

2.3 MSMEs from the Perspective of Bank

The survey also explores information and perception of banking sector about loan extension to MSMEs. Banks propose that the criteria of MSMEs in getting loan should be based on business scale measured by asset, yearly revenue, and number of labor, as well as credit limit.

Table 2.2 MSMEs Business Scale Proposed by Banks (Rp million)

	ASSET	REVENUE	LABOR
Micro	119 – 369	44.6 - 346.3	1 – 8
Small	1,500 - 2,100	543 - 3,300	8 – 35
Medium	4,000 - 31,500	3,000 - 27,000	35 – 138

US\$1 = Rp9,100

To increase the share of loan to MSMEs, internally banks provide special training to their employees/ loan officers, relax requirements and simplify procedure, and expand office network. While externally banks engage in partnership with rural banks through linkage program for micro and small enterprises, and cooperate with credit underwriter institutions for medium enterprises. Most banks believe that MSMEs are potential market for their loan, since MSMEs are considered as highly profitable business. Almost all banks perceive that the key success factor in extending loan to MSMEs is in feasibility study analysis, collection strategy, and embedded control.

In calculating interest rate for MSMEs loan, banks usually determine that the higher the credit limit, the lower the risk premium, and the lower the margin. So that, interest rate for micro credit generally is higher than interest rate for small and medium credit. It is believed that micro credit risk is higher than small or medium credit risk, so that there should be an innovation to lower risk premium to lower interest rate. Some of these innovations are credit underwriting and linkage program between commercial bank and rural bank.

In order to improve collection rate of MSMEs loan, all commercial and rural banks agree on the improvement of credit supervision/monitoring. Whereas, the assistance needed by bank to improve loan extension to MSMEs is on customer information and potential economic sectors. MSMEs, banks, and government institutions agree that skilled labor is the most important variable that performs poorly. Moreover, MSMEs and banks also believe that obtaining business permits is the second most important variable to be improved. These two variables should be given priority attention by the regulators to develop and improve MSMEs optimally.

3. The Strategy to Enhance Islamic Financial Services for MSMEs

3.1 The Role of Islamic Financial Institutions in Indonesian Economy

After the financial crisis of 1997/1998, MSMEs have been growing rapidly, since they are considered to be sustainable and crisis proof business entities with smaller scale and better quality and price for the customers. Consequently, the growth of MSMEs has also influenced the growth of financing demand that can also be fulfilled by Islamic financial institutions (IFIs). IFIs have become favorite alternatives for these new entrepreneurs, since they believed that the strength of profit-and-loss sharing (PLS) concept adopted by IFIs has saved them from the sharp fall of conventional banking industries due to negative spread and economic crisis (Pulungan and Karim, 2001).

Islamic financial institutions (IFIs) started to emerge in Indonesia in the early 1980s with the establishment of *Baitut Tamwil-Salman* in Bandung and *Koperasi Ridho Gusti* in Jakarta. The first Islamic Bank in Indonesia, Bank Muamalat Indonesia, established in 1992. The development of Islamic bank has been accelerated since Bank Indonesia (the central bank of Indonesia) allowed conventional banks to open Islamic branch. This Islamic branch can offer Islamic banking products and services separated from its conventional parent with its own infrastructure, including staff and branches. The Islamic banking system in Indonesia is currently represented by 3 Islamic banks, 20 Islamic branches, and 92 Rural Islamic Banks, with 620 offices and 439 office channelings, as well as 3400 BMTs (Islamic microfinance institutions), spreaded through out the country. They offer comprehensive and wide range of Islamic financial products and services and cater 1.54% of the banking market share.

Other than Islamic banks and Islamic nonblank financial institutions, other types of IFIs are also mushrooming in Indonesia, such as Islamic Finance Companies, Islamic Unit Trusts, and Takaful. Therefore, Islamic financial system has been developing like that in conventional (Rosly, 2005).

Even though the share of IFIs in Indonesian economy still relatively small, they are growing very rapidly. It is expected that the Islamic banking industry in Indonesia will reach 5% of the banking market share in 2008, excluding Islamic rural banks and Islamic microfinance institutions. Moreover, more than two third of Islamic banks' financing portfolios are

extended to MSMEs, while 100 percent of rural Islamic banks and BMTs financing portfolios are extended to MSMEs. Therefore IFIs in Indonesia play very important role to provide Islamic financial services to MSMEs, especially to micro and small enterprises.

3.2 Strategies to Enhance Islamic Financial Services to MSMEs

In general, Islamic financial services provided by IFIs in Indonesia can be segmented into several groups. *First*, Islamic banks usually are reluctant to enter financing market of less than Rp50 million (US\$5,500), so that enterprises covered by Islamic banks are especially large, medium, and (few) small enterprises. However, to channel financing to micro and small enterprises (MSEs), many Islamic banks cooperate with Islamic rural banks and MBTs to provide financing to MSEs. *Second*, Islamic rural banks mostly extend financing of less than Rp500 million (US\$55,000), so that the market served include small and micro enterprises. *Third*, BMTs mostly extend their financing of less than Rp50 million (US\$5,500), so that their main customers are micro enterprises.

Medium enterprises are considered to have the least needed assistance, since all of them should have business permits and in the form of formal business institutions with at least semi formal organization. Moreover, based on the discussions on chapter one and chapter two, it can be concluded that medium enterprises are relatively do not have any problem related to access to financing, since they are mostly formal corporation equipped with all necessary permits and legal documentations, so that they are very much bankable. Moreover, sound medium enterprises usually are approached by many financial institutions to offer credit/financing at prime rate to them, since these medium enterprises have proved to be viable and profitable businesses. Therefore, what Islamic financial institutions, especially Islamic Banks, can do is to offer better and innovative products and services needed by medium enterprises to improve the efficiency and quality of all their financial transactions.

Meanwhile, MSEs are still in need of assistance, especially financial assistance from government or donor. Government programs or grants to MSEs usually, among others, are partnered with Islamic banks, Islamic rural banks, or BMTs. Therefore, the financial channeling networks to MSEs can be illustrated in figure 3.1. Some of the channeling models, among others, are Ministry of Cooperative and SMEs model, Swamitra model, and Islamic bank model.

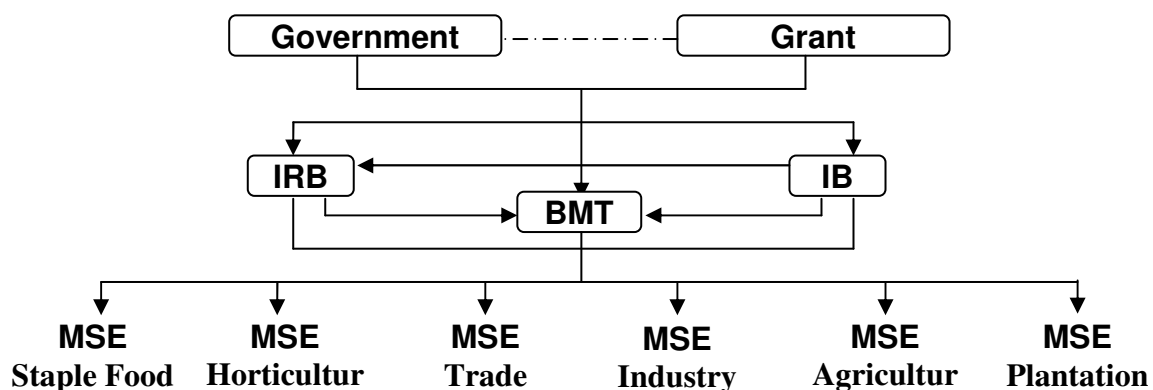


Figure 3.1 Channeling Networks to MSEs

3.2.1 Ministry of Cooperative and SMEs Model

This channeling model is a government program (Ministry of Cooperative and SMEs) to provide financing to MSEs in various sectors through conventional banks and cooperatives or

through Islamic banks and BMTs. The latter network uses Islamic mode of financing, i.e. *mudharabah muqayyadah* channeling, where Islamic banks act as an agent of the government to channel funds to selected BMTs. Subsequently, the BMTs will extend financing to selected MSEs. One example, this program has been implemented in Bogor, West Java, where one Islamic Bank (Bank Syariah Mandiri, Bogor Branch) channels Rp250 million funds from Ministry of Cooperative and SMEs to five BMTs (Rp50 million for each BMT) to finance micro enterprises up to Rp2 million for each micro enterprise.

Table 3.1 Mudharabah Muqayyadah to BMT through BSM (Rp million)

Baitul Maal wa Tamwiel	Channeled Fund
Asyifa	50
Ikhlasul Umah	50
Azima	50
Buana Jaya	50
Uber Kami	50

3.2.2 Swamitra Model

The swamitra model is a (five-year) partnership between Bukopin bank and cooperative (conventional and Islamic) to establish modern franchised microfinance institution called Swamitra Unit to provide financial services (deposit, financing, and services) to MSEs in various sectors with advanced management, technology and network. The area of business covered by Swawitra units include trader in traditional market, craftsman, farmer, fisherman, micro business, small business, and individuals who in need of capital for various productive activities. Bukopin bank will provide the system, training, and share capital, ranged between Rp500 million – Rp2.5 billion. In the case of Islamic Swamitra Unit, the profit and loss sharing between Islamic Swamitra Unit and financing customer is 80:20, with financing limit up to Rp150 million.

The first five Swamitra units established in 1997, and currently thousands of Swamitra units have been established in more than 20 provinces throughout Indonesia. For example, at the end of 2006, there are 145 Swamitra Mina or Fishery (52 on-line and 93 off-line). The Swamitra on-line has total asset of Rp114.5 billion, total financing of Rp55.81 billion to 11,844 customers, and total deposit of Rp10.88 billion from 20,382 customers.

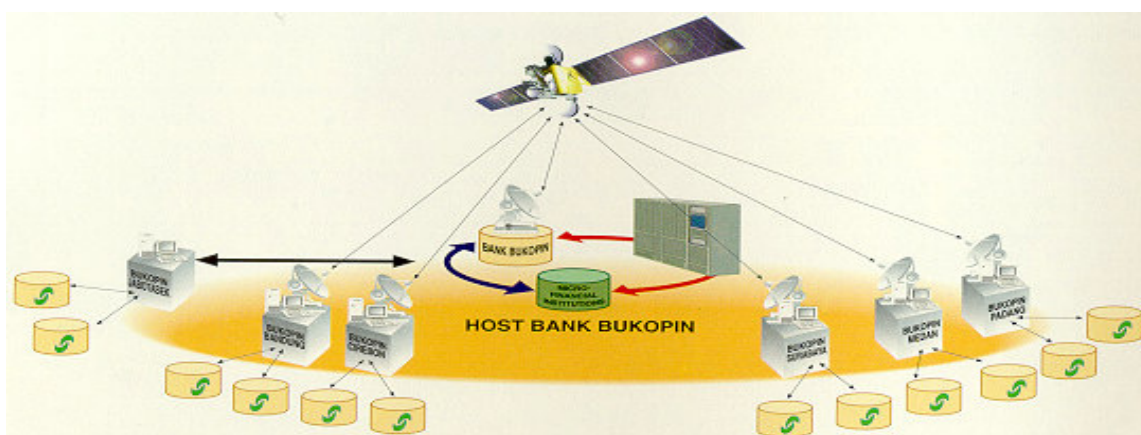


Figure 3.2 Bukopin – Swamitra Online System

Within this model, the responsibilities of Bukopin bank are: 1) maintain deposit/loan unit; 2) recruit, teach, and train new staffs; 3) provide working capital; and 4) provide investment capital. Meanwhile, the responsibilities of cooperative as partner are: 1) provide office space

and utilities; 2) extend financing to cooperative members; 3) provide assistance to members who receive financing; and 4) give recommendation for members who apply for financing.

In short, within the Swamitra program Bukopin bank offers training and management assistance and liquidity to its partners. These partners have to deposit capital in Bukopin bank and in return are assisted with setting up their business unit. The result can achieve the status of a “Swamitra branch” re-financed through this background and in close interaction with Bukopin bank itself. They may offer loan, savings and transfer services to customers in 20 provinces in Indonesia. The online network of Bukopin – Swamitra can be read in figure 3.2

3.2.3 Islamic Bank Model

Islamic bank model is a tailored channeling model designed by Islamic bank to channel funds to MSEs through Islamic rural banks and/or BMTs in specific areas. The model could be varying from one area to another depended on the specificity of the society and the SMEs to be financed. One example is the model implemented by Bank Muamalat Indonesia (BMI) to channel funds through Islamic rural bank in North Sumatera, where four Islamic rural banks were entered into *musharakah* partnership with BMI (30% IRB:70% BMI) to extend *murabahah* financing to MSEs (Pulungan and Karim, 2001).

Table 3.2 Musharakah Between BMI and IRB (Rp million)

Islamic Rural Bank	BMI (70%)	IRB (30%)	TOTAL
Gebu Prima	800	343	1143
Al Washliyah	170	73	243
Puduarta Insani	250	107	357
Rahmah Hijrah Agung	900	386	1286

Source: Pulungan and Karim (2001), modified.

Example of *murabahah* financing from IRB to customer is as follows:

Credit Limit	: Rp50,000,000
Utilization	: Working capital for jeans production
Tenor	: 36 months
Grace Period	: 2 months
Buying Price	: Rp50,000,000
Selling Price	: Rp82,446,820
Margin	: 36% effective p.a.
Installment	: Rp2,290,190
Administration Fee	: Rp500,000
Disbursement	: Based on production schedule

3.3 Modes of Financing

There are several modes of financing that can be applied to channel fund from the owner of the fund to the end customer. Some of them, among others, that widely applied are *mudharabah muqayyadah*, *mudharabah wal murabahah*, and *musharakah wal murabahah*.

3.3.1 Mudharabah Muqayyadah

Mudharabah muqayyadah is a channeling mode of financing facility from Islamic bank to MSEs through IRB or BMT as a channeling agent. Islamic bank as *shahibul maal* (capital owner) assign IRB/BMT as its agent to provide financing facilities to IRB/BMT customers, with certain criteria on place, purpose, or type of business to be financed. Then, IRB/BMT

will extend financing to MSEs as *mudharib* (entrepreneur) which match with the criteria determined by Islamic bank. As an agent, IRB/BMT will receive agency fee, while Islamic bank will fully responsible for profit/loss. Some important rules of *mudharabah muqayyadah* channeling (off balance sheet) are as follows:

1. Fund will be channeled directly to *mudharib* (customer);
2. Agent bank will receive commission fee;
3. Agent bank will issue proof of special investment; and
4. Agent bank will record the transaction off balanced sheet.

3.3.2 Mudharabah wal Murabahah

Mudharabah wal murabahah is a two-step mode of financing facility from Islamic bank to MSEs through IRB or BMT. First, Islamic bank as *shahibul maal* (capital owner) invests in IRB/BMT as a *mudharib* (entrepreneur) under *mudharabah* mode, to provide financing facilities to IRB/BMT customers, with pre-agreed profit/loss share, for example 30% for IRB/BMT and 70% for Islamic bank. Then, IRB/BMT as *ba'i* (seller) will extend financing to MSEs as *musytari* (buyer) under *murabahah* mode with pre-agreed margin.

3.3.3 Musharakah wal Murabahah

Musharakah wal murabahah is also a two-step financing mode to provide financing facility from Islamic bank to MSEs through IRB or BMT. In the first step, Islamic bank and IRB/BMT agree to cooperate and share under *musharakah* mode on providing financing facilities to IRB/BMT customers with pre-agreed portion, for example 30% from IRB/BMT and 70% from Islamic bank. In the second step, IRB/BMT as executing agent will extend financing to MSEs under *murabahah* mode. Since IRB/BMT takes more responsibility in this partnership, IRB/MBT will receive greater profit ratio than Islamic bank, for example 60:40. The extra 30% profit received will be posted as fee based income by IRB/BMT.

3.4 Supporting Infrastructure

MSEs are not only lack access to financial services, but they are also lack in knowledge, management, and technical ability to run their business in a sound manner. Therefore, financial assistance is necessary, but not sufficient. They also need other assistances, in production, marketing, management, etc. All of these needed assistances require infrastructures. The two most important supporting infrastructures can be seen in figure 3.3 in the form of underwriting institution and technical assistance.

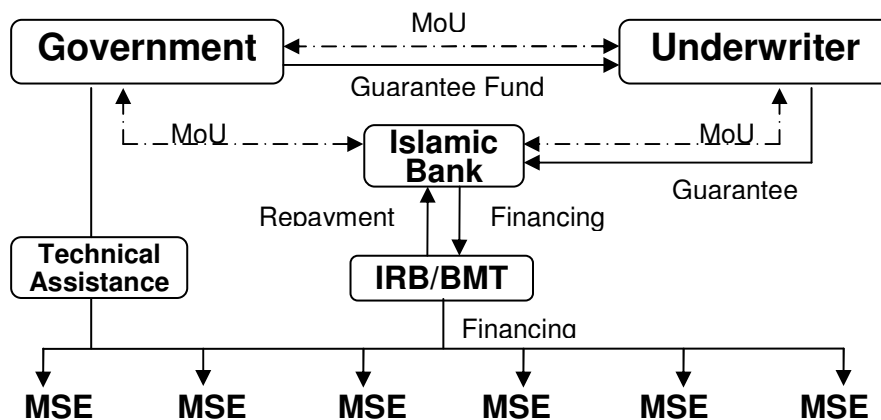


Figure 3.3 Supporting Infrastructures

3.4.1 Underwriting Institution

The survey shows that underwriting from government is one of the most needed aspects for banks to improve their financing to MSEs, since most of MSEs are not bankable due to lack of necessary collateral required for their financing applications. To substitute the collateral, underwriting institution is needed to provide credit guarantee to banks, so that financing intermediation to MSEs can run effectively. For this purpose, the Ministry of Cooperative and MSEs has allocated guarantee fund for MSEs financing. The underwriting institution will act as center control institution to cover the risk of fund extended to MSEs.

3.4.2 Technical Assistance

As mentioned above, the survey also shows that MSEs need technical assistance to educate and guide them to improve their productivity and capability to run their business soundly. According to survey, the most needed assistances to develop MSMEs businesses are technical skills in production and marketing, management business and finance, and computer skills. Marketing assistance could include market access, marketing coordination, market trend information, and business expo. Technical assistance can be conducted in many ways, such as monitoring, training, and evaluation.

4. Recommendations

Having identified the profile and problems of MSMEs in Indonesia, some recommendations can be formulated to improve and develop MSMEs in the future.

1. It is considered necessary to form a committee of MSMEs development chaired by the president or vice president with the member from departments and ministries, including Bank Indonesia, so that the formulation of MSMEs development policies is always on track and well coordinated in national or regional levels.
2. The development of MSMEs human resources should be focused on the improvement of skills, entrepreneurship, and technology. The government can actively involves in providing incentives and facilities to encourage cooperative between MSMEs and big corporations, universities, or research institutions. For example, the government should revive workshop centers, insert entrepreneurship in the high school curriculum, and provide tax incentives for MSMEs that cooperate with universities or research institutions to develop products through research and development.
3. The government should give assistance and attention to start up MSMEs to go through initial stage of their development to survive and maintain existence, especially in difficult economic time, through providing financing facility, since it is difficult for MSMEs, especially starts up, to obtain financing from banks or other financial institutions.
4. Simplifying the process of obtaining business and legal permits in all regions, which already done in several regions by applying one-door policy to process business permits. Moreover, it is necessary for MSMEs development through legal and regulation aspects that support intellectual property rights and business competition regulation.

5. The government should enhance its role in disseminating market information, including enhancing the role of embassies in obtaining information regarding export market opportunities.
6. To better serve MSMEs, Islamic banks should focus to serve medium enterprises, rural Islamic banks should focus to serve small enterprises, while BMTs should focus to serve micro enterprises. The government can provide some incentives for these strategies to be working effectively.

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