Available online at www.sciencedirect.com
SciVerse ScienceDirect
Procedia - Social and Behavioral Sciences 52 (2012) 179 – 186
Procedia
Social and Behavioral Sciences

10th Triple Helix Conference 2012

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

Aulia Nurul Huda*

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

Abstract

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

Keywords: *Indonesia, SME Financing, Developing Countries, Islamic Financing*

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

1877-0428 © 2012 The Authors. Published by Elsevier B.V. Selection and/or peer-review under responsibility of Institut Teknologi Bandung
doi:10.1016/j.sbspro.2012.09.454

1. Introduction

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

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

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

2. Methodology

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

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

3. Islamic Banking System and Practice

3.1. Islamic Banking System

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

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

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