

The Role of Profit-and-loss sharing Contracts In Strengthening Financing Access of Small Medium Enterprise's (SME's): The Case of Indonesia

By Naelati Tubastuvi



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Small and Medium Enterprises (SME's) have been faced various problems and capital as the critical issue, due to limited access to financing from banks. Islamic banks as an intermediary institution with the principle of profit sharing as a main character, has an important role in supporting SME's. This paper examines the effect of Profit-and-loss sharing (PLS) contracts on the financing access. PLS contracts are proxied by funding and financing based on profit-and-loss sharing, and financing access of SME's are proxied by Micro Enterprises Financing, Micro Enterprises Outreach, SME's Financing and SME's Outreach. The data collected from *Otoritas Jasa Keuangan* (OJK) database from 2014-2016 and conducted on Indonesian Islamic Banks. Structural Equation Model (SEM) analysis has been adopted to analyze the obtained data. The final sample used in this study of a total of 108 observations. The result showed that PLS contracts positively affect the financing access of SME's. This study suggests that the higher PLS Contracts in SME's business operations plays an important role in providing SMEs with a greater access to financing.

Keywords: Financing Access; Islamic Banks; Profit-and-Loss Sharing Contract; Small Medium Enterprises (SMEs)

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Small and Medium Enterprises (SME's) have been faced various problems and capital as the critical issue, due to limited access to financing from banks. Islamic banks as an intermediary institution with the principle of profit sharing as a main character, has an important role in supporting SME's. This paper examines the effect of Profit-and-loss sharing (PLS) contracts on the financing access. PLS contracts are proxied by funding and financing based on profit-and-loss sharing, and financing access of SME's are proxied by Micro Enterprises Financing, Micro Enterprises Outreach, SME's Financing and SME's Outreach. The data collected from *Otoritas Jasa Keuangan* (OJK) database from 2014-2016 and conducted on Indonesian Islamic Banks. Structural Equation Model (SEM) analysis has been adopted to analyze the obtained data. The final sample used in this study of a total of 108 observations. The result showed that PLS contracts positively affect the financing access of SME's. This study suggests that the higher PLS Contracts in SME's business operations plays an important role in providing SMEs with a greater access to financing.

Key words: Islamic Banks, Profit-and-loss sharing Contract, Financing Access, Small Medium Enterprises (SMEs)

1. INTRODUCTION

Micro small and medium enterprises (SME's) have an important role in the development of strategic and national economy. SME'S has labor absorption rate of around 97% of the national workforce and has contributed to the gross domestic product (GDP) of about 57%. Nevertheless, the issue surrounding classical of financing and enterprise development still remains attached to SME'S. Based on existing data, from 56.4 million UMK that exists throughout Indonesia, the new 30% who are able to access financing. The percentage of 76.1%, get credit from banks and 23.9% accessing from non banks including efforts save loan such as cooperatives. In other words, about 60%-70% of the whole sector of SME'S do not have access to financing through banking.¹ These conditions lead to SME'S cannot thrive, and space is limited. Therefore, an important effort for SME'S to get access to banking, particularly access to Islamic banking which has few options contract according customer needs.

The growth of Islamic Banking in Indonesia is quite massive and has the potential to continue to grow in the future. The growth rate of Islamic banking business volume averaged between 15-20% per year. The intermediation function of Islamic banks in Indonesia is in funding and financing showed good progress. The financial performance of Islamic Banking for 3 (three) years increases shown by the growth of third party funds (DPK) increased during the 3 years with an average of 149% per year. The high growth of third party funds shows the growing public confidence in Islamic banking in Indonesia. However, this growth is not accompanied by other financial performance such as Non Performing Financing (NPF) which continues to increase from year to year with an average of 3.76% during 2014-2016, rising NPF illustrates that Islamic banking faces financing problems and needs to increase risk management in its financing analysis. Another indicator of the performance of Islamic banks is the decline of the Financing Deposit Ratio (FDR), which averages 96% over the last 3 years, which means the liquidity needs of Islamic banking is getting low.²

Islamic banking is present as a manifestation of the aspirations of society who want economic activities based on sharia principles. On conventional banking there is only one principle that is interest, then on Islamic financial institutions there are choice of principles that can be adapted to customers need, namely the principle of profit sharing, the principle of sale and purchase, the principle of lease, and the principle of service. One of the precise principles devoted to the empowerment of SME'S is the principle of profit sharing. Generally the principle of profit sharing can be done in four contracts, namely *mudarabah*, *musharakah*, *muzara'ah*, and *musaqah*. In practice, however, the most widely used profit sharing contract is *mudarabah* and *musharakah*. The portion of bank financing based on *mudarabah* contracts (non PLS contracts) is still very high at 70% of total financing. Islamic banks are principally profit-sharing banks, so profit-sharing financing should be more dominant. One of the factors that led to the low share of financing for this result is the Islamic Bank is too prioritized business orientation and profit as business institutions in general, but less attention to the vision, mission, and objectives of Islamic banks for the benefit of the ummah. Therefore, it is necessary to supervise and rule by the government in this case Bank Indonesia and the supportive Financial Services Authority, such as about the measurement of bank health as well as on collectibility and collateral for financing the profit sharing so that it is more applicable and not burdensome for the banks and customers but instead encourages them to be more like use a profit-sharing contracts.³

In relation to this, many previous studies implied profit-and-loss sharing (PLS) contracts as an alternative financing for SMEs as it does not put heavy burdens on SMEs with high interest/ profit payment and collateral requirement and provides the SMEs with a better access to financing.⁴⁻⁵ Apart from this scholars,⁷⁻⁸ are of the opinion that PLS contracts is the true spirit of financing in Islam as it promotes justice which is the primary vision of Islam.⁹

In view of the above, this study is conducted to investigate the effect of Profit-and-loss sharing (PLS) contracts on the financing access.¹¹ PLS contracts are proxied by funding and financing based on profit-and-loss sharing, and financing access of SME's are proxied by Micro Enterprises Financing, Micro Enterprises Outreach, SME's Financing and SME's Outreach.

Profit-and-loss sharing (PLS) financing offers equity participation in the business venture where the banks hold ownership or become a partner in the firms. One of the main differences between PLS contracts and debt based financing is that provides the banks with a right to participate in the business operations of the firm financed by the banks. According to⁹⁻¹¹, one of PLS contracts called *musharaka* gives the banks a right to give a direct access to the business information which will significantly assist the banks to conduct effective monitoring and supervision of the business. PLS contracts as the Islamic financing principles are better appropriate than conventional contracts for meeting the urge of SME's. In most cases, financing is granted without an obligation on the part of the partner to repay whether he or she gains or loses. Moreover, no strict security is demanded, as Islamic investment arrangements put great priority on the transaction itself, rather than the credit worthiness of the partner.¹²

Profit-and-loss sharing ratios are determined on the basis of many factors. One of which is the degree of competition which proxied by Herfindahl-Hirschman Index (HHI). The higher HHI indicates that the market is more monopolistic. Therefore, that outcome argues that in a more monopolistic market, the Islamic microfinance institutions facing relatively lower competition and having ability to dominate the market so that it could lead to higher net profit margin of the Islamic microfinance institutions.¹³ Other factor is a customer or firm's past and expected performance. Banks do not claim a share in the profits on an equal footing, which otherwise would mean sharing profits in strict proportion to the bank's financing of the capital of a customer.

The profit-and-loss sharing system gives SME's opportunity to expand its business on the principle of partnership as the basic concept of Islamic banks. In the PLS contract the determination of the ratio or ratio of the PLS is determined at the time of the contract by considering the possibility of profit and loss. If the customer runs the project, the loss will be shared. PLS contracts allow for an increase in the amount of earnings by the amount of revenue. Interest system in conventional bank is still not pay attention to customer condition, so burden SME's. Determination of PLS contract in financing to SME's makes business management more optimal. Customers will really earn a profit, because the source of their business income depends on their hard work. PLS contracts become a fair system for both parties namely Islamic banks and SME's.

Financing Access is a major issue and a concern of efforts to improve SME's competitiveness. Financing Access to institutions can be presented by the vast network of financial institutions, the number of financing, funding and adult populations with access to finance.⁹

To address high social inequality and disparities, several countries including Indonesia are implementing inclusive financial programs, namely: the availability of savings services, payment services, barrier-free financing, both price and non-price. So far, the poor and SMEs are not served by formal financial institutions due to strict requirements, so they are trapped debt bondage to the moneylenders. Therefore, programs that are more appropriate to the social and economic conditions of the poor and SMEs are needed. inclusive finance is determined by several factors, accessibility of savings and security, access to financing, access to transfer facilities, and access to insurance products.¹⁴

The roles of an Islamic bank as an entrepreneur (*mudharib*) on the liability-side and as a capital provider (*shahibul mal*) on the asset-side provide unique and different indications on the funding and financing relations.¹⁵ It shows that PLS contracts are able to minimize unfair and transaction cost. Consequently, Islamic banks maximize their net profits and create value to SME's.¹⁶ relationship is illustrated in Figure 1 below where profit-and-loss sharing contracts of Islamic Bank becomes the independent variable, and SME's financing access is the dependent variable.

It is therefore hypothesized that :

H1 : Profit-and-loss sharing contract of Islamic bank will significant positively strengthen financing access of SME's

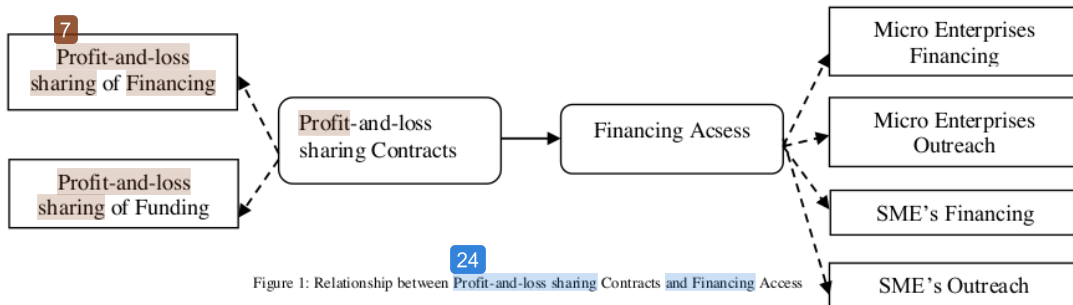


Figure 1: Relationship between Profit-and-loss sharing Contracts and Financing Access

2. MATERIALS AND METHODS

This research was conducted on the entire Islamic Indonesia (BUS) in Indonesia that has been operating above five years and publish quarterly financial reports. The data were analyzed on a quantitative approach in this study is secondary data there are the panel data, which is a combination of cross sectional data and time series data with quarterly period. The location of this study in Central Bank of Indonesia and Financial Service Authority. The data used in this research is a quarterly financial report 1 (first) 2014 up to 3 (third) quarter of 2016. The final sample used in this study of a total of 108 observations.

Profit-and-loss sharing consists of indicators :

X_1 = Profit-and-loss sharing Financing, namely the ratio of mudharabah-musyarakah financing to total financing in the same period.

X_2 = Profit-and-loss sharing Funding, namely the ratio of mudharabah-musyarakah financing to total funding in the same period.

Financing Access consists of indicators :

Y_1 = Micro Enterprise Financing, measured by the percentage (%) of Small Business Loans (KUK) to total receivables and financing

Y_2 = Micro Enterprise Outreach, measured by the percentage (%) number of Small Business Loans (KUK) customers to total number of customers

Y_3 = SME's Financing, measured by the percentage (%) of SME's Financing to total receivables and financing

Y_4 = SME's Outreach, measured by the percentage (%) number of SME's customers to total number of customers

Processing and data analysis using Structural Equation Modeling (SEM) using AMOS 4.0 and SPSS 10.1. SEM is a statistical modelling technique used to examine the relationship between latent independent constructs and dependent constructs.

3. RESULT AND DISCUSSION

Based on the results of the development of models and strong theoretical justification, it can be determined this research model as follows:

Independent variable : Profit Loss Sharing Contracts (PLS)

Dependent variable : Financing Access (FIN)

Equation : $PLS = 54,363FIN$ Access

Equation of research model can be explained table 1 below

Table 1. Equation of Research Model

Exogenous	Endogenous
$X_{1_1} = 0,818KSY + \epsilon_1$	$Y_{_1} = 1,316KIN + \epsilon_4$
$X_{1_2} = 0,711KSY + \epsilon_3$	$Y_{_2} = 0,754KIN + \epsilon_5$
	$Y_{_3} = 0,739KIN + \epsilon_6$
	$Y_{_4} = 0,717KIN + \epsilon_7$

The value of the loading factor of each indicator of latent variable financing access is greater than 0.5 which means it has fulfilled the convergent validity in SEM

analysis. The output of confirmatory factor analysis results can be made a summary of the results as shown in Table 2.

Table 2. Regression Weights Confirmatory Factor Analysis

	Causal	Estimate	S.E.	C.R.	
Y3	<---	Financial Access	.860	.226	3.810
Y4	<---	Financial Access	1.526	.349	4.376
Y2	<---	Financial Access	1.475	.333	4.428
Y1	<---	Financial Access	1.000		

	Causal	Estimate	S.E.	C.R.
x1	<---	1.000		
x3	<---	9.796	2.760	3.549

The data in Table 2 shows that the critical ratio (CR) value of each indicator is greater than 2.0. Therefore, it can be stated that each indicator is proven to meet

unidimensionality so that it can be followed by full model SEM analysis

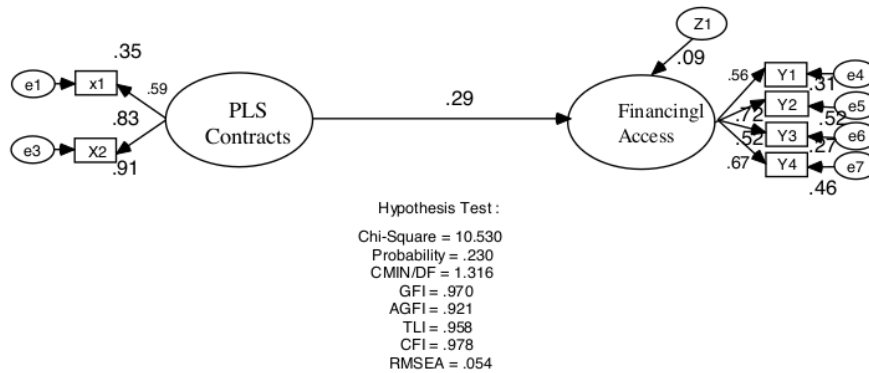


Figure 2. Full Model SEM Analysis

Goodness of Fit Criteria

Testing goodness of fit the model is done through a review of the criteria of goodness of fit, with the following results:

The result of normality test to the research data shows that each indicator of latent variable has a critical ratio skewness value less than ± 2.58 , indicating that the data is normally distributed. The result of univariate outliers test shows that the z-score of all indicators forming latent variables in this study is smaller than ± 3.00 which proves that the research data is free from univariate outliers. Multivariate outliers were evaluated on the basis of the comparison between the expensive hormone distance and the chi-square value of the table using $df = 6$ (number of indicators) and error rate = 0.001 (6; 0.001 = 22.46). Based on these criteria, it can be seen that the highest value of the expensive mobilization distance is 21.833 is smaller than the value of chi-square table, so it can be stated that this research data proved free from multivariate outliers. The determinant of sample covariance matrix in this study is 462056964886.016 far larger than zero, so it can be stated that there is no multicollinearity and singularity, so the data in this study is feasible to use.

The Goodness of fit test shows that the constructs in the research model are fit with the research data, shown by goodness of fit index (X2 Chi Square = 10.530, Probability = 0.23, CMIN / DF = 1.316, GFI = 0.970, AGFI = 0.921, TLI = 0.958, CFI = 0.978, RMSEA=0.054). The significance of causal relationships in SEM analysis is tested through the null hypothesis that the coefficients of causal relationships between variables are equal to zero through the t-test commonly used in regression analysis. Based on the analysis output of full SEM model, it is known that the critical ratio value (CR) for the influence of profit-and-loss sharing contracts toward financing access 2.150 is bigger than t value of 1.660 table. Therefore, the null hypothesis which states

that the regression weight is equal to zero is rejected, or it can be stated that the significance of the causal relationship in the model is acceptable. Thus the hypothesis that profit-and-loss sharing contracts have a positive and significant effect on financing access is accepted.

The result showed that PLS contracts positively affect the financing access of SME's. This causal relationship demonstrates that the higher level of profit-and-loss sharing contracts Islamic banks, it will be increasingly higher levels of SME's financing access in Indonesia. This can be explained that the higher of PLS contracts will enhance Micro Enterprises Financing, Micro Enterprises Outreach, SME's Financing and SME's Outreach. The results of this study supports the previous theoretical studies of that the element of participation in Musharakah financing is found to have a significant causal effect towards SMEs access to financing. This finding empirically supports earlier studies of which highlighted the importance of bank's participation in Profit-and-loss sharing contracts both financing and funding toward financing access of SME's

Distinctly, this result is in contrast to the findings of previous studies which found that SMEs are not suitable to the banks' participation in their business activities. Studies by^{18 19} found that micro and small businesses are not affected in PLS based financing due to the bank's participation which allows them to disruption in the management of their business. Some possible explanations of SMEs' agreement on the banks' participation in their operations as found in this study could be due to the assistance they will get from the banks' expertise, particularly in providing financial management cooperation.

4. CONCLUSION

2 This study confirmed that the implementation of profit and loss-sharing contracts on Islamic banks will support to the development of SME's through ease of access to financing. Profit-and-loss sharing contracts are well suited to the needs of society, in order to overcome the high gap of the economy. Currently Indonesia's economic system has not been fully sided of SME's, in particular in access to capital. Many rules and regulations are burdensome to this type of business, so SME's are often judged not to meet the criteria of the recipient. The interest-based financial system has been proven to benefit only the owners of capital, but on the one hand it harms those in need of capital. The profit-and-loss sharing system Islamic banking with mudharaba or musharaka instruments as a substitute for interest-based credit system has proven able to improve SME's financial access so as to enhance their competitiveness.

The next researcher needs to develop a causal relationship model between PLS contracts and financing access through the addition of other independent variables and need to consider adding a moderating variable or adding a mediating variable based on theoretical and empirical studies. Subsequent research also needs to expand the scope of research or subjects studied, for example in Islamic microfinance.

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