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Why Do Bank Finance Clients Prefer Mark-up to Profit Loss Sharing Principles? Evidence from Islamic Rural Banks and Small to Medium Enterprises in Indonesia

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ABSTRACT

This study examines the preferences of Islamic rural banks clients in choosing Islamic financial contracts to finance their business. Mixed method, combining quantitative and qualitative approaches, was adopted in this study. Quantitative data was gathered from the Indonesian Financial Service Authority to examine the preferences of small to medium enterprises (SMEs) in utilizing types of Islamic financial contracts. Qualitative data was collected by interviewing Islamic Rural Bank (BPRS) managers to investigate the reasons for choices of types of Islamic financing contracts. The finding shows that people prefer to use contracts under mark-up principles rather than profit loss sharing (PLS) principles. Simplicity of the contracts was the main reason for choosing mark-up contracts. This trend affects the growth of *mudaraba* and *musharaka* contracts, and ultimately the growth of Islamic banks.

Keywords: Islamic Bank, Small to Medium Enterprises Preferences, Profit and Loss Sharing
JEL Classification: G210

1. INTRODUCTION

The practice of Islamic banking (IB) has grown exponentially over the past four decades since the inception of an Islamic Bank in Dubai in 1975 (Elfakhani et al., 2009). The asset of Islamic banks was estimated to have reached $1.6 trillion by the end of 2014[1]. Although IB was formally established in the 1970s, historically, the practice of saving and financing based on Islamic law evolved since the 1960s. For example, the *Mit Ghamr* local savings Bank was established in Egypt in 1963 (Kahf, 2004).

In Indonesia, the presence of Islamic banks (IBs) is relatively new compared to conventional banks (CB). The first Islamic bank in Indonesia, Bank *Muamalat* Indonesia, was established in 1991 and started operations in 1992. Currently, there are 12 Islamic Commercial Banks (BUS), 24 IB Windows/Units (UUS), and 163 Islamic Rural Banks (BPRS) operating across Indonesia.

Although IBs have gained overall acceptance for commercial and personal service, it has been suggested that they have a pivotal role to play in servicing SMEs, in particular, where SMEs lack collateral, financial information and a track record. Therefore, the presence and growth of Islamic banks provides an opportunity for the development of SMEs due to the focus of IBs on equity and share of risk. Thus, Islamic banks serve as an alternative source of capital to that of CB. The difficulty of accessing capital from external sources, in particular for SMEs at the start-up and development stages (Beck, 2007), has been recognized by many scholars and supported by research findings (Beck et al., 2006; Bruns and Fletcher, 2008; Klonowski, 2012; Mason and Kwok, 2010; Wu et al., 2008). Bank finance is often provided for short-term purposes and there are limited financial institution products for long-term investment financing that enable entrepreneurs to plan their business activities and operations. Short-term finance, such as the overdraft facility, makes it difficult for SMEs to plan their firm's operations, and develop capacity and competitive products.

1 http://www.kfhresearch.com/product/islamic-finance-outlook-2014.

Banks consider SMEs to be risky propositions, in particular those seeking long-term loans. SMEs are often unable to either fulfill bank requirements at the start of the loan application as they do not have either a proven track record or adequate financial information to convince banks that they are capable of servicing their loan. Due to the lack of information and inadequate track record, banks demand large collateral to protect themselves against business failure. Insufficient collateral gives rise to a finance gap for SMEs (Beck et al., 2006). Deakins and Hussain (1994) argue that in the UK banks fail to evaluate business proposals on merit. Bank managers tend to rely on collateral to mitigate adverse outcomes in the case of business failure. In addition to seeking collateral, banks also impose relatively high interest rates to compensate them for high risk. Thus, SMEs encounter a double barrier to growth, namely the difficulties of accessing funds and the high cost of capital. The finance constraints faced by SMEs in Indonesia are not unique as research conducted in the UK, the USA and elsewhere report similar problems for SMEs.

It has been observed (Chen, 2006; Lauder et al., 1994; Tambunan, 2011) that SMEs, both in developed (USA, UK, Germany, France) and developing countries (China, India, Indonesia and others), have an important role to play towards economic recovery and growth. In the context of Indonesia, SMEs play a significant role and contribute to employment and GDP. The data of the Indonesian Ministry of Cooperative and small and medium enterprises reported that, including micro firms, there were 56,534,592 SMEs in 2012[2] and this represents an increase of as much as 2.41% from 2011. SMEs are spread across rural and urban Indonesia. In inner cities, SMEs have greater access to loans from banking institutions because most bank headquarters are located in cities.

Although in Indonesia the number of IBs has grown significantly, their percentage of assets and market share remains low compared to the total banking system. Empirical research over the last two decades has identified the demand factors that have influenced the growth in Islamic banks in many countries, but the focus of this research has been customers' point of view (Al-Ajmi et al., 2009; Dusuki and Abdullah, 2007; Erol and El-Bdour, 1989; Gait and Worthington, 2007; Gerrard and Cunningham, 1997; Haque et al., 2009; Haron et al., 1994; Rammal and Zurbruegg, 2007). There are, however, limited studies that examine the obstacles faced by Islamic banks from the supply side. Abdul Rahman et al. (Abdul-Rahman et al., 2014) evaluate the reason behind the failure of Islamic financial contracts under profit and loss sharing principles from the supply side from a theoretical perspective.

This study also evaluates the failure of applying profit loss sharing (PLS) from the supply side, but it is seen from the practical reasons according to the Islamic bank managers' points of view. Specifically, this study examines the preference of utilizing types of Islamic financial contracts. Although, theoretically, Islamic financial contracts under PLS principles have some advantages, the data on Islamic contracts gathered from the Indonesian Financial Service Authority (*Otoritas Jasa Keuangan. Indonesia*/OJK) shows that the percentage of mark-up principle contracts is greater than of PLS contracts. Why do we see this pattern? The reason for this finding will be explored by analyzing the opinions of BPRS managers through in-depth interview.

The remainder of the paper is structured as follows. Section 2 reviews literature related to this study. Section 3 outlines the research methodology adopted in this research. Section 4 explains and discusses the finding. Finally, section 5, is the conclusion.

2. LITERATURE REVIEW

A number of authors have examined access to finance for SMEs in developed and developing economies (Beck, 2007; Beck and Demirguc-Kunt, 2006; Berger and Udell, 2006; McPherson and Rous, 2010; Mudd, 2012; Valverde et al., 2009). The focus of academic research has been on SMEs and their relationship and issues with CB. These authors generally highlight the difficulties SMEs face in accessing external financing, a factor which limits their growth. Government policy to motivate financial institutions to facilitate financial access for SMEs is important to support SME growth (Beck and Demirguc-Kunt, 2006). As Beck and Kunt argue, the importance of developing SMEs is based on two premises: '(1) SMEs are the engines of growth, and, (2) market imperfections and institutional weaknesses impede their growth' (p. 2). They suggest the main obstacle to growth for SMEs is difficulty in accessing external sources of funding. Therefore, the development of legal regulations and financial institutions plays an important role in reducing barriers to finance. It has been suggested that small businesses are preferable to larger firms in countries which have better financial institutions and further that governments should provide support and guidance to financial institutions to enable SMEs to prosper.

Beck (Beck, 2007) argues that financial constraints for SMEs are more severe in economies with under-developed and weakened financial systems; these are common characteristics of many developing economies like Indonesia. The weaknesses of financial institutions combined with transaction costs and asymmetric information are factors that give rise to a finance gap for SMEs in developing and developed countries. The investment opportunity for firms is highly dependent - to the extent that firms can incur capital to fund their investments. ValVerde et al. (2008) investigates financing constraints and SME investment using samples from Spanish SMEs to estimate the correlation between bank loans and investment, trade credit and investment, and accounts receivable and bank loans, as well as causal links. They reported that trade credit is a predictor of cash constraint for investment for firms. This indicates that due to constraints, firms prefer to choose trade credit due to the limited access to bank loans in comparison to unconstrained firms. Furthermore, ValVerde et al. (2009) highlights the correlation between bank competition and SME financing in that market power increases a firm's financing constraints.

The difficulties in accessing formal finance for SMEs are referred to as the "financing gap." The term gap describes the inaccessibility of formal finance (sources of finance such as banks, capital markets

2 The latest data available that can be accessed.

or other suppliers of finance (OECD, 2006) that in turn prevent SMEs from having an optimal financing structure. It is argued that the existence of asymmetric information (where banks are unable access full information on the borrower and therefore have insufficient information upon which to evaluate risk) makes this gap worse. In addition, the gap is affected by certain circumstances such as 'domestic savings investment balance, legal, institutional and regulatory framework, and structure of the financial system' (OECD, 2006).

The presence of Islamic banks should be an alternative source of financing for SMEs and decrease the financial gap for SMEs. To respond to the finance gap for SMEs in the economy, governments have adapted various policies to assist the development of SMEs. In addition to conventional policies and measures used to support SMEs, it is now suggested that Islamic bank finance is a suitable source of finance to meet the needs of SMEs. It is suggested that Islamic finance overcomes issues related to asymmetric information and collateral as the provider of finance shares profit and risk, which mitigates the need for financial information and collateral often required by traditional banks. Theoretically, the issue of the obligation of borrower to provide collateral should be ignored in Islamic banks particularly in PLS-based contracts because the PLS principle necessitates that the bank bears risk along with the enterpreneurs. This is the advantage of Islamic banks often found in Islamic bank literature.

Although the PLS principle is one advantage of Islamic banks, many authors criticize the low application of PLS in practice. Based on their study in Malaysia, Chong and Liu (Chong and Liu, 2009) argue that the application of PLS based financing is a negligible proportion of total Islamic bank financing. This implies that Islamic banks provide more mark-up than PLS based financing which resembles the interest rates of CB. This circumstance leads them to argue that in practice there is no difference between Islamic and CB. This opinion is confirmed in the study by Ahmad and Haron (2002) in which respondents believed that only the name of the contract differed to show that it was an Islamic-based bank contract and that interest was still charged. Thus, PLS principles that should be a feature of Islamic banks that attracts new borrowers in practice does not. As a result, the PLS mode of finance is not the main driver boosting the development of Islamic banks. The rapid growth of Islamic banks is mainly driven by the Islamic resurgence worldwide rather than the advantage of the PLS paradigm (Chong and Liu, 2009).

Azmat et al. (2015) found similar evidence that Islamic banks seem to prefer to provide more conventional debt contracts. Through the development of their theoretical model, their study found that asymmetric information and risk averse depositors affected the low level of PLS application. They explain further that a borrowing firm can maximize their profit more through debt contracts than through Islamic joint ventures based on PLS principle in the presence of asymmetric information and risk averse depositors. Since this condition will be always there, Islamic banks are not likely to offer more PLS based contracts in the future. Furthermore, the PLS mode of finance will not be the power through which Islamic banks grow. This circumstance is augmented by the lack of understanding of the borrower about revenue sharing, which leads Muslim borrowers to feel more at ease engaging with CB (Wulandari and Subagio, 2015).

Hamza (2016) examines the compliance of investment deposit return with the profit and loss sharing principle. Using regression analysis, Hamza (2016) found that investment deposit return does not reflect the PLS principle for two main reasons related to Islamic bank behavior and investment account holders. From the Islamic bank side, the explanation is mostly related to the moral hazard for the Islamic bank manager who takes excessive risks in their relationships with investment account holders. Besides, investment account holders have limited information about funding strategies and Islamic banks risk exposition. From the investment account holders' side, they refuse low returns, which are contrary to their return expectations, which leads Islamic banks to engage in tight price competition with CB.

Criticism of the practices of Islamic banks are also conveyed by Khan (2010). He argues that most Islamic banks are functionally indistinguishable from CB. This is because in reality most Islamic banks prefer to provide debt-like financing instruments rather than PLS based schemes. Regarding this issue, Huda (Huda, 2012) explains that the application of profit-loss sharing can be increased if the problem of asymmetric information is reduced. The low level of utilization of the PLS mode of finance in most countries indicates that this type of contract is not advantageous to Islamic banks, as is acknowledged in practice. Potential borrowers from Islamic banks are not enticed by the attractiveness of the PLS mode of finance, but rather by other issues. The opinion that the practice of Islamic banks is indistingusihable form CB, based on the reality that Islamic banks prefer to provide mark-up principles, may discourage the development of Islamic banks.

The other issue that hinders the growth of Islamic banks is the awareness of Muslim borrowers about Islamic bank transactions. Jaffar and Musa (2014) found it ironic that in practice in Malaysia although Islamic finance and *halal* sectors are shariah-compliant business entities sharing similar values, markets and principles, there has been disconnection between Islamic finance and *halal* sectors. The disconnection is evidenced by the low penetration of Islamic banks in *halal* sectors. Intuitively, being the owners of true *halal* businesses, the players should not only concentrate on *halal* production but most importantly finance their business through *halal*-based financing. However, this has not occured. Only 5% of industry players are involved with Islamic banks and use *halal* finance products while the rest use non-Islamic financial instruments (Jaffar and Musa, 2014).

3. DATA AND METHODOLOGY

This research adopts a mixed method which combines quantitative and qualitative methods to cope with the disadvantages of each method and to strengthen the validity of the results[3]. Mixed method is advantageous in terms of providing a more comprehensive

3 The combination of these methods is alternatively termed triangulation.

analysis since the weaknesses of one method will be corroborated with another method (Creswell, 2013).

Quantitative data which consists of macro data on IB was collected from the Indonesian Financial Authority Service website. The data analysed covered a 5 year period to enable the examination of the trends in utilizing types of contracts. Meanwhile, qualitative data was gathered through in-depth interview with Islamic rural bank managers (BPRS) located in central Java, Indonesia.

The analysis in this study adopts Bryman's (2012) notion in which 'both approaches are given equal emphasis' in order to produce a general picture. The purpose of the quantitative method is to depict the pattern of the preferences of SMEs in utilizing Islamic financial contracts in financing their businesses. Meanwhile, a qualitative method is used to corroborate the findings of the quantitative method.

Comparison method was adopted to analyze the quantitative data to compare the percentage of each type of Islamic financial contract. This finding will provide a picture of the preferences of SMEs in using Islamic finance instruments served by Islamic banks. The qualitative data was analyzed using interpretive analysis to find the reason underlying the preference of BPRS regarding Islamic finance contracts to serve their borrowers.

4. FINDINGS AND DISCUSSION

Different types of contract are used for the purposes of lending to individuals and businesses. The contracts range and types vary, but the key products or contracts available in the market are *mudarabah, musharakah, salam, murabahah, istisna, ijara, qordh* and multipurpose financing.

Unlike fully-fledged Islamic banks, Islamic rural banks make use of other instruments such as *salam* (purchase of specified goods for forward payment) but these account for a very small (<1%) proportion of total transactions. While, Islamic commercial banks use the term "other" contract, Islamic rural banks (BPRS) use the term "multipurpose financing" which accounts for 4.65% of transactions. Like Islamic banks in general, BPRS also rely on *murabahah* contracts which represent nearly 80% of their total transactions (Table 1).

The reason for the popularity of *murabahah* is its simplicity. Even the contract that is suitable under PLS scheme is converted into mark-up principles, particularly the *murabaha* contract.

> *In Indonesia, the murabahah contract covers 80-90%t of transactions as most actors do not fully understand Islamic financial contract types. So, contracts which would ordinarily be described as mudarabah or musharakah are converted to the murabahah contract (BR3)*.

Table 2 summarizes the use of Islamic financial contracts based on PLS and mark-up principles. Although Islamic law promotes the use of PLS based contracts, namely *mudaraba* or *musharaka,* the use of contracts based on PLS is much less than of those based on mark-up principles. Evidence gleaned from data gathered from the Indonesian Financial Service Authority (OJK) suggests that the parties involved in Islamic bank transactions prefer mark-up based principles which account for 87.21% of transactions whereas PLS contracts only account for 12.79% of the total market share. The high preference for utilizing mark-up schemes is because this scheme is considered simpler than the PLS scheme. This is true particularly because the target market of BPRS are SMEs which have difficulties providing audited financial statements.

In addition, mark-up based financing does not require transparency and honesty of borrowers in providing profit reports. Thus, the lower use of PLS-based financing confirms the opinion that SME's are opaque firms (Berger and Udell, 2006). The high preference for using contracts based on mark-up principles leads to the view that the practices of Islamic banks are no different to those of CB. In fact, people assume that access to Islamic banks is more complicated than to CB. For example, when borrowers visit CB to acquire loans, the banks offer interest as a price of the loan regardless of the borrowers' needs. In contrast, Islamic banks ask details of the borrowers' requisites in order to provide a specific product for their requirements. As BR6 reported:

> *Obviously people do not yet fully understand Islamic banks and when introduced to IBs, peoples' response was that "it is too complicated, not as simple as a CB." People lack familiarity with IB.*

Another major factor that influences and constrains the growth of IBs is consumer mindset or consumer views in relation to IBs. Due to inadequate knowledge of Islamic teachings, borrowers cannot distinguish between conventional and Islamic banks and argue that both charge 'interest'.

> *We face much difficulty because of the old mindset. They say, "what's the difference between conventional and Islamic banks?" (BR4).*

Table 1: Financing Composition of Islamic Rural Banks (in Million Rupiah)

Types of contract	2011	%	2012	%	2013	%	2014	%	2015	%	Average (%)
Mudharaba	75,807	3	99,361	3	1,06,851	2	1,22,467	2	1,68,516	3	2.68
Musharaka	2,46,796	9	3,21,131	9	4,26,528	10	567,658	11	652,316	11	10.11
Murabaha	2.1,54,494	81	2.8,54,646	80	3.5,46,361	80	3.9,65,543	79	4.4,91,697	78	79.60
Salam	20	0	197	0	26	0	16	0	15	0	0.00
Istishna	23,673	1	20,751	1	17,614	0	12,881	0	11,135	0	0.46
Ijara	13,815	1	13,522	0	8,318	0	5,179	0	6,175	0	0.26
Qardh	72,095	3	81,666	2	93,325	2	97,709	2	123,588	2	2.24
Multi purpose financing	89,230	3	1,62,245	5	2,34,469	5	2,33,456	5	3,11,729	5	4.65
Total	2.6,75,930		3.5,53,519		4.4,33,492		5.0,04,909		5.7,65,171		

Table 2: Percentage of PLS compared to mark-up contracts of Islamic rural banks

Types of contract	Average for five years (%)	Average mode of finance
Mudharaba	2.68	PLS comprises of
Musharaka	10.11	12.79%
Murabaha	79.60	Mark-up comprises of 87.21%
Salam	0.00	
Istishna	0.46	
Ijara	0.26	
Qardh	2.24	
Multi-purpose financing	4.65	

PLS: Profit loss sharing

The most difficult aspect of marketing IBs is to change people's mindset; they assume that the Islamic bank is no different to the CB (BR7).

If the assumption about the similarity of IBs and CBs does not change, borrowers will prefer CB to Islamic banks, in particular those customers who are engaged with banks in the pursuit of profit. In contrast, customers of Islamic banks are motivated by their religion and tend to conform to bank requirements. This group of people is often referred to as emotionally motivated, and the Islamic banks target this group in particular.

Changing mindsets is not so easy, because they are formed over a long period. Therefore, we are prioritizing emotional motives, those who are eager to engage in shariah. Hopefully, in the future, our customers will move from an emotional motive to a rational motive (BR5).

We classify people into three groups. The first category is emotional. This group is easy [to invite], the importance for them is only shariah. The other is the rational [group]. We have to have different approaches towards [each group]. At the start, it was the emotional group that was much more interested (BR8).

The challenge for the proponents of IBs is how to promote IBs amongst rational groups. It has been suggested that to promote IBs, Islamic scholars need to promote Islamic finance education to inform the Muslim population. Although *fatwa* (religious decree) prohibiting interest payments exist, the declaration of a *fatwa*, and the publicity surrounding the *fatwa*, can damage the image and equity of a brand. Again, although a *fatwa* was declared by the Indonesian Council of Islamic Scholars *Majelis Ulama Indonesia* (MUI) it did not have a significant impact on the growth of Islamic banks.

A fatwa on riba (interest) is like a fatwa on smoking. Although the MUI launched a fatwa stating that smoking is haram (forbidden), most Indonesian Muslims ignore it. Similarly, the MUI launched a fatwa that interest is unlawful, and the fact remains that many people ignore that fatwa. People deem that conventional and shariah banks are one and the same (BR3).

While it is probable that education related to Islamic financing may promote familiarity with and effectiveness of IB, this education must be underpinned by appropriate legislation. The Indonesian government lacks the initiative and pace to legislate to promote IBs. To regulate Islamic banks, the government launched law no. 21 in 2008 which specifically addresses issues related to the operational aspects of Islamic banks. It may be argued, however, that this law was too little, too late - especially for a majority Muslim country.

5. CONCLUSION

Although many Islamic scholars are of the view that the PLS scheme is an advantage of Islamic banks, people prefer Islamic financial contracts that use mark-up principles. This preference is evidenced by the high percentage of mark-up schemes practiced by Islamic banks, both Islamic commercial or rural banks, in Indonesia. The preference for using mark-up contracts is based on the opinion that these types of contract are relatively simpler than those under the PLS principle. As a result, people avoid PLS contracts. This circumstance affects the growth of *mudaraba* and *musharaka* contracts, which differentiate Islamic banks from CB, and ultimately affects the growth of Islamic banks.

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