SMEs Financing Innovation
Application of Hawalah in Islamic Cooperative
(Case Study)

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Abstract

Purpose – This paper analyses a case study of Islamic cooperative and the problems it faced in the Islamic financial system of Indonesia. Accordingly, it proposes a financing innovation, an enhanced structure of Shari‘ah compliant hawalah financing scheme, which could improve operations of the cooperative. Discussions on factors contributing to successful implementation of the instrument are also included.

Methodology/Approach – The research uses a case study approach and qualitative research methods, particularly semi-structured interview, to explore practical problems faced by the cooperative and accordingly suggest relevant recommendations.

Findings – The hawalah-based financing could be used to facilitate and partnership between SMEs (muhaal), Islamic cooperative (muhaal-alaih) and corporate/business-partner (as muhil). Benefits from using the scheme could further be enhanced if appropriate mechanism, risk management practices and partnership with relevant institutions (Islamic banks, government agencies and donor organizations) are in place.

Practical Implications – First, appropriate hawalah-based financing could be used as an alternative solution to financial problems faced by Islamic SMEs. Second, IFIs could potentially provide the scheme, particularly for SMEs/clients in need for managing their account receivable, which also underpin the importance of developing wider ranges of Islamic financial products that meet the need of their stakeholders. Finally, partnerships with relevant institutions are necessary especially for SMEs which contribute significantly to the economy.

Originality/Value of Paper – Analysis of hawalah contract is relatively new in Islamic finance literature, particularly in the Indonesian context. A case study on Islamic cooperative and SMEs may also give some new insights into the existing Islamic literature.

Keywords: Hawalah financing, SMEs financing, financial product innovation, Islamic microfinance, Islamic cooperative.
Introduction
Small and Micro Enterprises (SMEs) is the largest business group in Indonesia. In 2009, around 52 million SMEs exist which constitutes approximately 99.99% of all business in the country. In terms of labor, the sector absorbs close to 96 million employments (97.3% of the total labor force). All together, SMEs contributes to 58.27% of the country’s GDP (Table 1). This clearly shows the importance of SMEs in the Indonesian economic development.

<table>
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<tr>
<th>Number</th>
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Table 1: Profile of SMEs in Indonesia in 2009

Despite the importance of SMEs, in practice it faces many challenges (see Box 1). A survey conducted by the Indonesian Ministry of Cooperative, Small and Medium Enterprises (MCSME) reports that approximately 72.47% of the SMEs have obstacles in their business operation. Major obstacles are financial problems, particularly in acquiring working capital. Other problems include marketing (35%), raw material (9%), human resources (1%) and other problems (Yasni 2007).

With regard to the financing problem, a large number of SMEs have actually tried to access capital from commercial banks. However, most of them could not get the financing needed for various reasons, from lack of collateral to small amount of financing needed (Ascarya and Yumanita, 2007). In addition, mismatch between SMEs’ demand (especially in trading sector) and financing mechanisms involving large firms frequently happen, ¹ which often resulted in lower production and productivity of real sector. This condition worsens when the banks reduced their credit target due to unfavorable economic conditions, as evident after the 2008/2009 global financial crisis. ²

These problems reflect challenges for government and financial institutions, especially Islamic Financial Institutions (IFIs), to develop SMEs which are expected to become the engine of economic growth in Indonesia. Accordingly, barriers to SMEs development must be reduced. In a short term, financial and non-financial assistances should be provided to ensure SMEs business sustainability (Panggabean, 2005). In a longer term,

¹ For example, in the trading between SMEs and large firm, the firm normally receives goods from the SMEs and pays them back once the goods sold. This normally takes 1-3 months to be settled. Thus, the SMEs need to have enough capital to continue productions while waiting for the payment. Some SMEs could probably get the (additional) financing from commercial banks or other non-bank sources (such as borrowing from relatives). However, many of them simply reduce or stop production when the capital is not available. If this situation happened persistently, real sector development and hence income distribution and economic growth will be deteriorated.
² Bank Mandiri, the biggest bank in Indonesia, for instance has reduced the credit target from 22% to 18%. Furthermore, it lowered the interest rate offered to depositors to approximately 7-10%, while keeping the interest rate for borrower at the rate of 16-20%. Panin Bank, another big Indonesian bank, also cut their credit expansion from 30% to 25%. “Krisis Likuiditas Perbankan (Banking Liquidity Crisis)”, Investor Magazine, X/184, October 2008, pp. 20.
innovations in financial products need to be encouraged and fairer business regulations between various businesses entities need to be developed (Ainley, et al, 2007). Well-developed and fair market is an important objective to be achieved by Islamic economic system (Kahf, 2000).

**Box 1. Profiles and Problems of SMEs in Indonesia**

The SMEs sector in Indonesia has proven itself to be the main element that supports the country’s economic growth. A survey conducted by Bank Indonesia in 2005 on 11,000 SMEs from four economic sectors (trade, industry, service, and agriculture) reveals that (1) small enterprises took a major portion (49.4%) among the SMEs (respondents); (2) majority of the SMEs conduct their business in trading sector (34.4%); and (3) most of the SMEs did not took any financing from the bank for various reasons (Ascarya and Yumanita, 2007).

The survey also finds that majority of the SMEs have no debts to any types of banking institutions. In particular, it is found that most of the non-debtors (64.6%) actually need the loan, but majority of them (74%) did not apply to the bank because they were afraid of having debt and because of the high interest-rate charged by the conventional bank. Of those who want to apply the loan to conventional bank, only 54% did actually apply for the loan. The rest did not apply because they could not fulfill the banks’ administrative requirements and afraid of the high interest rate. Another reason that hinders the SMEs to apply for the loan is the banks’ perception that SMEs’ financing is a high risk financing. Not surprisingly, some banks have tendency to make the loan application procedure become more difficult (Yasni, 2007).

Nevertheless, most of the applicants who are eligible and meet the banks’ requirements (84.5%) ended up with acceptance of their loan application. This is supported by the fact that the SMEs are actually promising debtors. As revealed by the survey, majority of SMEs have high profit margin. Most of the micro and small enterprises enjoy relatively high profit margin between 10% and 50%, while that of the medium enterprises are mostly up to 10% (Figure 2).
Given these backgrounds, the study analyzes and develops an Islamic financial product that potentially suitable for SMEs in the trading sector. As a case study, we investigate Propindo Islamic Cooperative, an independent Islamic cooperative pioneered by a group of small traders in Jakarta Indonesia. The cooperative recently experiments a new financing scheme called hawalah-based financing to provide additional working capital for their members.

Nevertheless, for some reasons, the financing has been suspended. This paper, therefore, analyses the problems, finds out the obstacles in implementing the financing scheme and suggests some relevant recommendations regarding its feasibility and implementation in the future.

To achieve the objectives above, it relies on both primary and secondary sources. The primary data is mainly collected through semi-structured interviews with the relevant parties including Propindo management and their members/partner SMEs, trading partner of the SMEs, Islamic banks and relevant government institutions. Meanwhile, the secondary sources are gathered from the existing literature on Islamic law (fiqh) in relation to Islamic financial products and official documents of Propindo. It is hoped that the case study could provide some insights in developing innovative Islamic financial products especially for SMEs and IFIs.

CONCEPTS OF HAWALAH

The SMEs profiles and challenges described earlier suggest that there is a potential market that could be developed by IFIs. The nature of IFIs which do not involve riba (interest) and gharar (speculation) on their business can be solutions especially for the entrepreneurs who have concerns both on Shari`ah compliance issues on borrowing based on ribawi scheme and on high interest rate. Unfortunately, this does not seem to be the case as clearly pointed out by the survey result.

Moreover, it is pointed out that IFIs are lacked of innovations. The IFIs in Indonesia seem to be more comfortable replicating the conventional banks’ products rather than developing the wide-range options for Islamic financial products/services (Republika, 2009). This is worsened by the reality that research on Islamic banking product development is very rare (Republika, 2010). Not surprisingly, as of December 2007, the types of Islamic banking products which were approved by Bank Indonesia are very limited (see Appendix 1). Hawalah-based products are yet to be on the lists. Given this perspective, this section discusses various aspects of hawalah contracts including its definition, Islamic perspectives on hawalah, pillars of hawalah, requirements of hawalah and potential application of hawalah.

Definition

Literally, hawalah means transfer or change from a locality to another locality or from a person to another person or from a situation to another situation (Usmani, 2005). While legally, the Hanafis define it as a transfer of liability for a debt from a legal personality of debtor to legal personality of the liable person named in the contract. The non-Hanafis defined almost the same meaning that the hawalah is a transfer of debt as a contract by means of which a debt is transferred from one person’s liability to another’s (Al-Zuhaily, 2003). From those definitions, it can be concluded that hawalah is a contract of debt transfer, not a guaranty one.

Note that although hawalah seems similar to the sale of debt, but it is not a sale indeed. It is a unique contract which has its own distinct features and conditions. The three important
participants in a hawalah contract are: muhil (principal debtor), muhaal (creditor) and muhaal alaih (debt transferee). When a valid hawalah is concluded, the debt is no longer demanded from the principal debtor. This is because in hawalah, the debt is transferred from the principal debtor to the transferee. Furthermore, hawalah establishes a right for the creditor to demand the settlement of debt from the transferee (Usmani, 2005). This definition and understanding are shared by the National Shari‘ah Board of Indonesian Council for Islamic Scholars (DSN-MUI). In their fatwa (consensus) No. 58/DSN-MUI/V/2007, hawalah is defined as a contract of debt transferring from a party to another party.

Islamic Perspectives on Hawalah

The use of hawalah is recommended by the majority of Fuqaha based on the hadith of the Prophet (pbuh) narrated by Abu Huraira.: “Procrastination in paying debts by a wealthy man is injustice. So, if your debt is transferred from your debtor to a trustworthy rich debtor you should agree.” (Shahih Bukhari, Hadith 487). The Hanafis, Hanbalis, Shafi‘is and Malikis agree that the hawalah is permissible although each of the jurisdictions has their own opinions regarding the cornerstones of the hawalah contract (Al-Zuhaily 2003: 51). Moreover, hawalah is permissible by the jurists as there is recourse to the principal debtor debtor if the transferee does not pay the debt for any reason. This unlike sale of debt where the purchaser of the debt instrument has no recourse to the seller of the debt, and therefore, due to the involvement of gharar and riba (Ayub, 2007: 168).

Pillars of Hawalah

Jumhur ulama (the majority of scholars), including DSN-MUI in Indonesia, believed that hawalah is valid when five pillars are fulfilled (Bank Indonesia 2006:17):
- muhil (principal debtor),
- muhaal (creditor (or transferor)),
- muhaal ‘alaih (transferee)
- muhaal bih (principal debtor’s debt to creditor)
- sighat ijab qabul (agreement of offer and acceptance).

Furthermore, DSN-MUI divides hawalah contract into two types of contracts, namely hawalah muqayyadah and hawalah muthlaqah. Hawalah muqayyadah is a hawalah contract where principal debtor is the party who has liability to creditor and at the same time has receivable to transferee. Slightly different, hawalah muthlaqah is a hawalah contract where principal debtor is the party who has liability to creditor but has no receivable to transferee. Accordingly, only for hawalah muthlaqah that DSN-MUI permits transferee to take certain amount of ujrah (fees), but this amount should be clearly stated in the contract.4

Requirements for Hawalah

Fatwa of DSN-MUI affirms that for hawalah to be valid, it has to satisfy the following requirements. First, statement of offer and

4 In the fatwa on hawalah bil ujrah (hawalah with fee), the DSN-MUI legalised hawalah muthlaqah based on Holy Qur’an surah Al-Maidah (5): 1, Al-Baqarah (2): 282, some hadith of the Prophet (p.b.u.h), ijma’, Islamic legal maxims, and opinion expressed by Muslim jurists, such as Mushthafa ‘Abdullah al-Hamsyari as quoted by Syaiikh ‘Athiyah Shaqr in Ahsan al-Kalam fi al-Fatawa wa al-Ahkam, volume 5, p. 542-543. The latest source mentioned that hawalah, just as wakalah and kafalah, is common to be used as foundation contract of L/C. As L/C which conducted using Islamic contracts is permitted, thus fee generated from the contract is also permitted. This fatwa is issued mainly to support the Islamic financial institutions to develop their products to meet the demand of their customers.
acceptance has to be notated by the contracting parties to show their willingness in doing the contract. Second, the contract shall be conveyed in writing, through correspondence or by using any mode of modern communication. Third, the contract has to be done by mutual consent of the principal debtor, creditor and transferee. Fourth, the rights and obligations of the contracting parties have to be mentioned clearly in the contract. Finally, when the contract is concluded, only creditor and transferee involve in the contract (Bank Indonesia 2006:15).

Potential Application of Hawalah
Hawalah contract can be used by modern Islamic banks in the form of cheques, drafts, pay orders, remittances, promissory notes, bills of exchange and any other trading facilities that require transfer of debt (Ayub, 2007: 168). The implementation, however, is relatively underdeveloped and unexplored in most of Muslim countries, including Indonesia. It is suggested that Hawalah-based financing can be utilised in the trading sector involving IFIs, especially Islamic microfinance institutions. Thus, it is also potential to be applied in fostering the development of SMEs as will be further elaborated further in this paper.

METHODOLOGY AND DATA
This research is basically an inductive and exploratory study based on real problems faced by IFIs. The specific case analysed is the Propindo Islamic Cooperative (Koperasi Syariah Propindo) and the Muslim entrepreneurs who become its members. It examines problems faced by the cooperative that tried to introduce a presumably hawalah-based financing in its operations and accordingly proposes some alternative solutions for the problems. This research uses case study design and qualitative research method to obtain the relevant data and arrive at conclusive results. The primary data is obtained from semi-structured interviews with the director and vice-director of Propindo in May and August 2008 respectively. In addition to the primary data, secondary data such as official documents from the cooperative are also collected. To gain more perspectives and clarify the problems identified, early findings of this study were also discussed with Islamic banking practitioners and officers of relevant government agencies.

Based on the investigations, the next section explains the profiles of Propindo Islamic Cooperative and elaborates its hawalah-based financing experiment. It also identifies and analyses the practical problems associated with the mode of financing. These are the basis for the model modifications discussed in the subsequent section.

THE CASE STUDY: HAWALAH – BASED FINANCING EXPERIMENT BY PROPINDO

Case Study Background
Propindo Islamic Cooperative was established in 2008, after previously operating as a conventional cooperative since 1995. This decision was taken based on aspiration of the members who regarded that Islamic cooperative structure could give them more benefits than the traditional structure, in addition to the fact that the new structure allows them to adhere and be more consistent with their faith. Profile and transformation of the cooperative is briefly summarised in Box 2.

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5 See again Appendix 1.

6 This is done by discussing early findings of the study, especially issues in implementing the model of hawalah-based financing, with several Islamic banks practitioners and officers government agencies (Bank Indonesia and MCSME) during a seminar at Bank Indonesia in November 2008.

7 Almost all of the cooperative members are Muslim. However, membership is not restricted to the Muslim only as clearly mentioned in the cooperative principles.
Recently, in addition to the working capital provided for the members, the cooperative has tried to develop extra financing facility targeted to the members in the trading sector. The need arises from ‘unfavorable’ trading mechanism when dealing with large companies such as supermarket and hypermarket chains. In the partnership between SMEs and a supermarket, for example, the supermarket usually receives goods from the SMEs and pays them back once the goods sold, usually within 1-3 months time. Thus, the supermarket pays using a term-payment system. This mechanism requires the SMEs to have enough working capital to continue productions while waiting for the payment.

This transaction mechanism creates additional burden for the SMEs in maintaining their

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8 Trading sector is one of the most promising SME sector in Indonesia, which also applies to this cooperative. Main business of the SMEs/cooperative member in this sector is providing raw material to other (big) businesses, such as supplying vegetable/fresh-food to supermarkets, hospitals, restaurants, catering and other similar business. According to one of the merchant, who is also an official of Propindo, potential of this business segment is very promising. It is estimated that the turn-over of this business achieves 500 trillion rupiah (100 million USD) per month in Jakarta and the surrounding areas.
business sustainability. Some SMEs could probably get (additional) financing from commercial banks or other non-bank sources.\(^9\) However, many of them simply reduce or stop production when the capital is not available. To help the SMEs/members, Propindo introduces the so-called hawalah-based financing scheme with financing amounts range from 500,000 to 5 million rupiah.\(^10\) Under the financing scheme, the hawalah-based financing is basically a financing structure based on hawalah contract where SMEs (the muhaal) transfer their receivable to the cooperative (the muhal’alaih). The cooperative then provides cash, based on the SMEs’ receivables values, and later collect the receivables from the SMEs’ trading partners (the muhil). Thus, the cooperative acts as a third party that takes over the SME’s receivables and provides ‘quick cash’ for working capital for the SMEs. As the return, it receives hawalah fee\(^11\) from the SMEs. To some extent, as also acknowledged by the directors, these mechanisms are similar to the conventional factoring mechanism.

**Practical Issues in Implementation of Hawalah – based Financing**

In early 2009, Propindo Cooperative made an agreement with a medium-size local supermarket which has several stores in Jakarta. Under the agreement, the cooperative acts as a third party that linked its members (the SMEs supplying goods to the supermarket) to the supermarket/partner (buying goods from the SMEs) based on the hawalah scheme described earlier. However, until now, the implementation was not even started.

Based on interview with Propindo management, there are three major problems that created obstacles to implement the potentially beneficial transaction. First, the ‘suspension’ was primarily due to the lack of fund for used by the SMEs for the partnership to work effectively. In one hand, the partner wanted to have a considerable amount of transactions, i.e. around two billion rupiah\(^12\) per transaction, so it could lower the transaction costs and benefit more from economies of scale. On the other hand, the cooperative could not provide such a large amount of money on a regular basis due to lack of funds.

Second, as the cooperative tried to get additional funding from IFIs and relevant government agency (i.e. MCSME), other problems appear. It is revealed that the institutions were ‘reluctant’ to give the funding for different reasons. The MCSME rejected the proposal mainly because they have no allocation and limited funds for this kind of ‘new’ scheme. However, further investigation suggests that the problem is beyond the technical problem, which is typically used by government agency to ‘blockage’ such demand. The main problem actually lies in the institutional-legal factor due to inexistence of specific law that regulates Islamic cooperatives in Indonesia.

Currently, Islamic cooperative is established under the (conventional) Cooperative Law No. 25/1992 because it is seen only as a ‘variant’ of cooperative. There is also no sign that a new bill will be issued soon due to complexity of law making process in Indonesia, especially when it involves religious related matter\(^13\).

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\(^9\) Example includes borrowing from relatives or friends.
\(^10\) Equivalent to USD 50-500, since 1 USD is approximately Rp 10,000 during 2008-2009 period.
\(^11\) The proposed fee depends on the financing period (FP). It is around 2.5% (FP < 1 month), 4.5% (FP = 1-2 months) and 6% (FP > 2 months). This rate will be multiplied with the hawalah financing given to the SMEs.
\(^12\) Equivalent to USD 200,000.
\(^13\) An interesting example is probably the Law of Zakah Management. It was initially proposed in 1968, yet it was agreed only in 1999 as the Law No 38/1999 on Zakah management. It is believed that the main reason behind constant rejection of the law proposal was fear of some groups...
Consequently, among others, there are no guidance and standards for management and operational of Islamic cooperative including in product/services innovations like hawalah-based financing.

The legal problem is also the main reason behind reluctance of Islamic banks to finance the proposal. Although hawalah contract has been legally recognised in the Indonesian Islamic financial system\textsuperscript{14}, as also inferred from discussion with the central bank officer, currently there is no financial product structured based on this contract.\textsuperscript{15} The lack of legal certainty makes IFIs reluctant to deal with clients with ‘unclear’ transaction proposal scheme. External factor presumably also influenced the bank’s decision. Apparently, the recent global financial crisis has forced the Indonesian banks operating to be more selective in giving credit/financing. It is evident that the crisis increases the probability of default and banking risks in general. As for the Islamic banks, cautions are ever higher because most of them already have high FDR (Financing-to-Deposit-Ratio). In November 2008, the FDR reached 111.7\% (Bank Indonesia, 2009). While this number probably lower after 2008, the ratio is still predicted to be high.

The final factor that impedes the proposal implementation is concern over risk management of such transaction. Two major risks are identified here. First, operational risk might happen if the client failed to pay the installment despite their membership with the cooperative. The risk maybe higher considering that it has limited funding. Second, Shari’ah compliant risk might happens as there was no clear basis for charging certain percentage of fee proposed in the transaction. While it is allowed to take some fee, strict Shari’ah stance requires this fee to be justified with the real costs to deliver the service. However, for simplicity, IFIs are often arbitrarily determined the fee. As in the case of murabaha or commodity murabaha (tawarruq) financing, some scholars argue that is similar to hiyal and could lead to the ‘back door’ practice of riba (Kasri and Kassim, 2009). This is where product ‘innovation’ is particularly relevant, as will be elaborated in the next section.

**ENHANCING HAWALAH FINANCING MECHANISM AND ITS APPLICATION**

**Hawalah Financing Mechanism**

In view of the above, we propose a general hawalah-based financing structure which potentially improves operational and risk management practices. Under this structure, there are three principle parties involved namely muhil (principal debtor), muhaal (creditor) and muhaal alaih (transferee). Interaction of these parties must be supported with clear flow of transactions backed by proper documentation and validation processes in relation to sighat ijab qabul (agreement of offer and acceptance) and muhaal bih (principal debtor’s debt to creditor) element. The mechanism, which is illustrated in Figure 1, essentially ensures validation of the five pillars of hawalah agreed by the scholars as well as ensure ‘just’ and Shari’ah compliant transactions.

Following our case study, three parties supposedly involved with the scheme is SME

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\textsuperscript{14} Based on the Fatwa DSN No. 58/DSN-MUI/V/2007.

\textsuperscript{15} See again Appendix 1.
(creditor), trading partner (principal debtor) and Islamic cooperative (transferee). Under the mechanism, initially SMEs supply particular goods to the partner. After checking quality and quantity of the ordered goods, the partner issues term payment current account (1-3 months) or cheque that can be cashed within a particular period. The SMEs pass the current account to the cooperative which subsequently checks the originality and validity of the financial instrument issued. Once the current account is validated, the cooperative issues cheque that can be disbursed and used by the SMEs as working capital. In return, it receives fee (ujrah) from the service provided based on agreements with the SMEs.

The mechanism described above provides several advantages to all parties. First, it provides additional working capital needed by the SMEs to continue production and sustain their business. Second, trading partners are benefited since they could continue their payment mechanism, secure stocks for their operation, enjoy economies of scale and maintain a good long-run relationship with their supplier. Third, the cooperative is also advantaged not only from the commission received but also from being able to help business of their members which in turn will enhance their business as well. From transactional perspective, fourth, the mechanism also provides better operation and risk management practices for the transactions. This can be seen from clear flow of transaction and the validation processes which potentially increases efficiency and trustworthiness in dealing with large firms. Finally, it enhances Shari`ah compliance through fee charging and distribution based on mutual consensus with the involved parties. In this case, cooperative structure has embodied advantage as the SMEs are actually members of the cooperative and thereby enjoy benefit from higher profits made by the cooperative. Overall, as the real sector
that employs most of the country’s human resources works more efficiently, this should be benefited the economy as a whole.

It is worth to note that the hawalah-fee proposed in this scheme is in-line with the principle of hawalah muthalaqah, where DSN of Indonesia allow such a fee charging. While this element could potentially be ‘abused’, this might not the case for Islamic cooperative whose profits are – at least in theory - eventually returned back to its members such as in our case study. However, since different business/sector have different risk structures, it is possible that the fee is structured in a way that these businesses are charged differently. This could be done with mutual consensus, since the SMEs are also member of the cooperative itself, or based on specific formula.

Strategy to Enhance Application of Hawalah based Financing

Previous findings of the study suggest that there are three major problems related to the practical implementation of the hawalah-based financing scheme, namely operational (product specific) and risk management, lack of funds and legal problems. While the hawalah-based financing proposed above provides alternative solution for the first problem, other problems remain exist.

With regard to the second problem, it is suggested that cooperative could be partnering with government, IFIs or donor organizations in providing funds to SMEs. This partnership could take form of (i) grant, technical assistance, etc from relevant institutions and (ii) specific financial contract, such as mudharaba and musyarakah, with Islamic banks or other IFIs. A possible partnership is illustrated in Figure 2 below.

![Figure 2: Suggested Partnership Models for Fund Provision](image)

The final problem indicates that the current legal infrastructure needs to be strengthened, not only to be more flexible with current business situation but also to be more accommodative to the needs of the society. Furthermore, product innovation needs to be encouraged and supported by relevant parties. In these areas, strong research based regulation and product innovation on Islamic-based-financial-scheme is a must. These are institutional and long-term tasks that should be done together by all Islamic finance stakeholders.

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16 For example, SMEs dealing with restaurants or hospitals (provide fresh food, vegetable, etc) have different needs and risk structures compared to the SMEs selling furniture to large furniture chains. In this example, the former may need smaller amount yet quicker/more frequent cash support, which might justify higher fee charging when compared to the latter.

17 The linkage mechanism in Figure 2 is encouraged by the Bank Indonesia to be done by Islamic banks so that the cooperative as well as other Islamic microfinance institutions (IMIs) can get more funds to be distributed to the SMEs through channeling and executing mechanism. In channeling mechanism, the IMIs are acting as agent of the banks to channel the banks’ funds. Thus the risks of financing will be on the banks’ side. For this cooperation, IMIs will get fee from the banks. In the executing mechanism, the banks trust the funds to be managed by the IMIs. Thus, any return and risk associated with the funds will be borne by the IMIs. Despite of the advantages of this scheme, there must be a regulation mentioning ‘rules of the game’ to be applied by Islamic banks and IMIs so that this cooperation will not bring to IMIs’ clients ‘cannibalization’ by the bigger Islamic banks. Currently, this regulation is still in drafting stage by the Bank Indonesia and other related institutions.
CONCLUDING REMARKS

This paper essentially analyses the case study of Propindo Islamic cooperative in the context of Islamic financial system of Indonesia. The cooperative tries to develop a new product, termed as hawalah financing which has never been used in Indonesia, yet failed to implement it. Investigation of this study suggests that there are at least three factors that hinder implementation of such innovative financial product. First, the cooperative could not channel a large amount of money to finance the SMEs on a regular basis due to lack of funds. Second, when the cooperative tried to get external additional funding sources from IFIs and relevant government agency, they were ‘reluctant’ to give the funding at that time due to some reasons. Finally, there is a concern on risk management (operational and Shari‘ah compliant) risks consequences of implementing such transaction.

Against this background, the study analyses and proposes a hawalah-based financing scheme which is not applicable yet in the Indonesian Islamic financial system. The structure could be used to facilitate mutual partnerships between SMEs (muhaal-creditor), Islamic cooperative (muhaal alaih-transferee) and partner (muhil-principal debtor). This paper also proposes a strategy to enhance application of this financial product by involving Islamic banking, government agencies and donor organizations.

It is expected that the application of such financing instrument could foster development of SMEs which is expected to be the ‘engine of growth’ for the Indonesian economy. In this regard, Islamic banks are hoped to be the ‘driver’ and main element in enhancing the SMEs’ role. In the long-run, with participation of all economic development stakeholders, greater role of SMEs is expected to increase welfare and reduce poverty which are the main goals of Islamic economics.

REFERENCES


Appendix 1: Islamic Banking Product in Indonesia

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<tr>
<td>Debt transfer</td>
<td>Qardh, Bai’, Murabahah</td>
</tr>
<tr>
<td>L/C - Export</td>
<td>Wakalah bil ujrah, Bai’, and Kafalah</td>
</tr>
<tr>
<td>L/C - Import</td>
<td>Wakalah, Kafalah</td>
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<tr>
<td>Pawn</td>
<td>Qardh and Ijarah</td>
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<table>
<thead>
<tr>
<th>Nature of Product/Service</th>
<th>Modes and Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumptive financing</td>
<td>Ijarah, IMBT, Paralel Istishna’a, Salam, Murabahah</td>
</tr>
<tr>
<td>Investment financing</td>
<td>Musyarakah, Mudharabah, Mudharabah Muqayyadah</td>
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<tr>
<td>Qardh Financing</td>
<td>Qardh</td>
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