

THE SOCIAL BENEFIT ANALYSIS OF ISLAMIC RURAL BANKS IN SUPPORTING FINANCIAL INCLUSION IN INDONESIA: EMPIRICAL EVIDENCE AND STRENGTHENING STRATEGIES

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Abstract

The development of Islamic Rural Banks in Indonesia claimed has made a major contribution in improving the development of micro real sector in rural area. In line with Islamic banking tagline "beyond banking", the outreach of Islamic rural banks to micro real sector by channeling the productive lending, is not only for profit orientation but also social benefit oriented. This paper is concerned with the issue of the outreach - the social benefit- of Islamic Rural banks in the term of six aspects: depth, breadth, scope, worth, cost and length. This paper gives an overview about of the social benefit of Islamic Rural Banks , the contribution of Islamic Rural Bank in creating financial inclusion and prove that financial inclusion program has actually existed before the program was popularized in Indonesia. The analysis based on the secondary data which come from the Directorate of Islamic Banking of Bank Indonesia, Financial Service Authority and the Islamic Rural Banks Annual Report in period 2006-2015. This study reveals that the outreach-social benefit- of Islamic rural banks have already increased for four aspect: depth, breadth, scope and length. However, it has not seen a good performance for aspect worth and cost. The limitations of human resource capacity, the lack of monitoring and technology, customers moral hazard, side-streaming of fund, and the limitation of managerial business of customers are the causes of the emergence of financing problems. The issue of efficiency and high cost of funding contributed for the poor performance of this social benefit. We discuss the implication of this study and recommend some policies.

Keywords : *Outreach, Social Benefits, Islamic Rural Banks, Real Sectors*

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1. Introduction

The issue of poverty is a complex problem faced by many developing countries including Indonesia. There are 27.73 million poor people in Indonesia within 2014, with the poverty rate reached 10.96% and 62.65% of them existed in rural areas. One of the popular solutions to reduce poverty are community development, and it will be more effective for the marginalized community, especially in rural areas. The productive sectors that grow in rural areas are agriculture, commerce and small industries, and generally these sector growing in small or micro scale. The share of Small-Medium Enterprises covers 99.99% of the existing business unit in Indonesia and a market share for micro sector reached 98.77 (Central Bureau of Statistics, 2014)

One of the important solution must be considered to recover Indonesian economy is applying the concepts of Islamic economics as Islamic banking. The success of real sector depends on the establishment of the monetary sector, because access to capital is derived from the monetary sector. The concept of Islamic banking is in line with the financial inclusion that have seized the international's attention in the G-20 forum since 2010. In principle, the concept of financial inclusion is a concept where there is ease of access to banking for all people.

Indonesia's economic structure which is dominated by small and medium micro economy, the concept of democracy economic and the booming of Islamic economics supported the development of Islamic banking based on social justiced. Islamic Rural Banks was the Islamic financial institutions that already exist in the application of financial inclusion it self long before the financial inclusion program spreaded. There were 163 Islamic Rural Banks with 402 branch office spread all across Indonesia in 2015.

Indicators "outreach or the social benefit" can be used to assess how far the influence of microfinance institutions for economic development, or at least can be a proxy to assess how far an microfinance institution has achieved its goal in providing social benefits for the poor. (Schreiner; 1999, Yaron; 1994, Yaron, Benjamin & Piprek; 1997). Related to the achievement of the mission of social benefit, these aspects of outreach covers several aspects namely: the worth of outreach, the cost of outreach, the depth of outreach, the breadth of outreach, the length of outreach, and the scope of outreach(Schreiner et al. 1999). One dilemma faced in realizing this mission is a trade-off between the target of outreach and financial sustainability, or in other words, the target of social responsibility and financial responsibility. Both of mission are equally important, but to maintain the financial sustainability of Microfinance Institutions need to take a few steps for these two things into balance. (Luong; 2010, Schreiner;1997 and Rao ;2014)

This study is aimed to analyze an empirical evidence about the issue of the outreach - the social benefit- of Islamic Rural banks in the term of six aspects: depth, breadth, scope, worth, cost and length Furthermore this study will contributes the recommendations to strengthen the local development strategy by implementing the Islamic Rural Banks as an icon of financial inclusion in rural area.

2. Survey of Literature

The concept of financial inclusion means "finance for all" (Sinclair, 2013). World Bank (2008) provides a definition about financial inclusion as an overall activity that aims to eliminate all forms of barrier in price or in non price barrier to access communities in using and utilizing financial service. Financial Action Task Forceprovides the definition "*financial inclusion involves providing access to an adequate range of safe, convenient and affordable financial services to disadvantaged and other vulnerable groups, including low income, rural*

and undocumented persons, who have been underserved or excluded from the formal financial sector”.

The Central Bank of Indonesia, as the institution that is responsible for the realization of financial inclusion strengthens the monetary climate by issuing a 23 point policy which includes five aspects, namely: 1) the policy for strengthening monetary stability, 2) Policy to develop the role of banking as intermediation, 3) Policy in increasing the resilience of the banking 4) strengthening macroprudential policy and 5) strengthening the supervisory functions. In an effort to realize the financial inclusion, Bank Indonesia has established six-pillar strategy that includes financial education, public finance facilities, mapping of financial information, policies, facilitating the intermediation and distribution channels and consumer protection (The Central Bank of Indonesia, Inclusive Finance, 2014)

Islamic Rural Banks is a kind of Rural Bank operating with the concept of Islam (UU No. 10 Tahun 1998 about Banking and UUNo.21 Tahun 2008 about Islamic Banking). In the economic empowerment of rural communities, Islamic Rural Banks comes with its primary function as a financial institution that was established to serve the Micro and Small Enterprises (SMEs). Islamic Rural Banks as intermediary institutions that have to expand the use of products in the financing and Islamic financing in their activities is the connecting bridge between the financial sector and real sector. Islamic Rural Banks prioritize transactions with productive oriented than consumptive. The purposes of Islamic Rural Banks Islam are 1) Improving the economic welfare of the Moslims, especially for the marginalized community located in rural areas, 2) Increasing employment opportunities, especially at the district level so that reduce urbanization and 3) Establishing Islamic interrelation (ukhuwah Islamiyah) through economic activity in order to increase of per capita income towards a better quality of life (Sumitro, 2004, p.130).

Implementation of the concept of financial inclusion in Indonesia is still quite low, because of many thing such as low level of financial literacy, community income is still low and financial institutions are still few. However, with the involvement of Rural Banks, financial inclusion in Indonesia began to rise because some of the flexibility offered by Rural Banks such as: 1) Rural Banks more closer to the people, especially the lower middle class, 2) Rural Banks also provides banking services which are easily accessible to the public. 3) Profit orientation taken by Rural banks are much smaller than commercial banks, so that the Rural Banks easier to attract the public, and 4) Rural Banks spread the financing to small and medium enterprises sector (SMEs)

Studies on microfinance institution got the momentum in the 1980s. The issues related to sustainability, products and services, the practical management of a microfinance institution management, client segmentation and impact assessment became more attractive in the review by some researchers. Many models and frameworks then applied in the management of microfinance and its impact on the poor. (Brau, 2004). Some literature provided an examination the impact of microcredit to the raising in productivity in various sectors and in various areas. Some Studies that tried to look deeper on how far microcredit able to touch the grass root, shows that the poor who become participants as the target client in the microcredit to be in better condition on average compared with non-client community (Yunus, 2007; Lønborg, 2014, Becchetti, 2011, Coleman, 2006). Some literature supported the facts that the existence of rural banks have an impact in the development of rural areas. The context of the selected area in Asia have been discussed by Turvey in the case in Shaanxi and Gansu provinces in the People's Republic of China (PRC), Duy (2012) in the case in Vietnam, Selinger (2008) in the case of Bangladesh.

The outreach or social benefit can be used as an indicator of microfinance institution's influence in economic development. The outreach-social benefit- can be used as a proxy extent to which an microfinance institution has achieved its goal in providing social benefits

for the poor (Schreiner; 2001, Yaron; 1994, Yaron; Benjamin & Piprek 1997). This indicator is divided into three sub-indicator that are the outreach of customers and staff, the outreach of loans and savings/deposits. The issue of outreach or social benefit become an obstacle in the development of Microfinance Institutions. As a financial institution that is closest to the lower levels of society (grass root), microfinance institutions is regarded as the most effective institution in overcoming poverty. One dilemma faced in realizing this mission is a trade-off between the target to increase outreach and financial sustainability or in other words for this institution to carry out social responsibility and financial responsibility at the other hand. Luong (2010), (Schreiner, 1997) and Rao (2014) are studies that tried to analyze issues related to trade off of this. They agreed that the mission is equally important, but to maintain the financial sustainability of Microfinance Institutions require different steps for achieving balance those two things.

Schreiner (1999) divided the aspect of outreach into six major aspects : worth, cost, depth, breadth, length, and scope. The worth of outreach is defined as the willingness of customers to pay for financing. The cost of outreach refers to the costs have to pay by the customer such as interest costs / margins and other transaction costs. The depth of refers to the depth of the social gains obtained by the public. The breadth of Outreach associated with the number of clients, which are determined by the constraints of the budget, wants and needs of the community. The length of outreach is the time frame of the supply of microfinance, which is not only measured than just profit. The scope of outreach is a type of financial contracts offered both products of funding and financing products.

3. Data and Methodology

Our Data come from the Islamic Banking Report published by the Directorate of Islamic Banking of Bank Indonesia and Financial Services Authority. The methodology applied in analyzing is a descriptive analytic approach to historical data in the last 10 years (2006-2015), by comparing data based on time cohort. This paper explain about indication financial inclusion in rural areas, and the social benefit of Islamic Rural Banks. This study also recommend the policies relating to optimalization Islamic Rural Banks's role in actualizing financial inclusion.

4. Findings

The development of Islamic Rural Banks becomes one of benchmarks the existence of Islamic Banks in economic development. Empirical evidence shows a real Acceleration of sharia banking development in Indonesia, especially Islamic Rural Banks (popular as Syariah Financing Bank Rakyat in Indonesia). Unlike the Islamic Commercial Banking, Islamic Rural banks focus on developing of rural economic in Indonesia with sharia principle. The development of Islamic Rural Bank in the future have a significant opportunity to Realize a shared vision of Islamic banking, financial inclusion or the "Bank for All". This vision is in line with Islamic banks tagline "Beyond Banking", banks that upholds social justice for all people.

One proxy for assessing the contribution of microfinance institutions in the development of society is by analyzing the outreach or the social benefits obtained society. In accordance with the purpose of its existence, is to provide services to micro and small enterprises of the poor, the best outreach is also based on how far the value of microfinance institutions were able to reach this segment. Following the approach of schreiner (1999) which divides aspect of this outreach into six major aspects of worth, cost, depth, breadth, length, and scope, analysis of social benefit of this Islamic Rural Banks in Indonesia can be seen through aspects of its social benefits.

First, Depth of Outreach. Its indicator refers to how poor people are helped by financing channeled by Islamic Rural Banks. Depth of Outreach refers to the depth of the social gains obtained by the public. In general, to measure the reach of financial services to the poor from a microfinance institution using the average outstanding of the loan (Cull et al., 2007; Mersland & Strom 2010; Hermes et al., 2011). More poorer the people who assisted increasingly within outreach. Or in other conditions, the smaller the scale of business of real sector empowered more deeper the outreach. Depth of outreach can be seen from the average outstanding financing. The assumption that the poor or micro sectors asking for a loan in the amount of small ones, the smaller the average funding channeled the more impoverished communities are financed. Empirical evidence showed in the period of 2006-2015, Islamic Rural Bank has channeled about 57.97% of the depositor funds to the sector of SMEs. This figure does not look dominant, because Islamic Rural Banks are still playing safe by channeling financing in consumptive lending, using murabaha contract. Nevertheless, based on the economic sector financed, show there are three main sectors financed by Islamic Rural Bank namely agriculture, forestry and agricultural facilities, restaurant and hotel trade sector and other sectors. These three sector is the leading sector dominated by micro small and medium enterprises. Its around 77.8% of the total financing extended to these sectors. Based on the purposes of financing observed that the financing for working capital and investment on average by 63.62%, and the rest for consumption. The distribution of this funding is quite capable to illustrates that the largest portion of the financing was allocated for the main segment of Islamic Rural Banks, they are poor people and micro real sector.

Second, Breadth of Outreach. This indicator showed how many poor people who can be served by microfinance. It is associated with a number of clients, which are determined by the constraints of the budget, wants and needs of the community. In the period 2006- 2015, the number of lending's clients that are serviced by Islamic Rural Bank always has increased every year, from 70.415 loan accounts in 2006 become 233.496 loan account in 2015. It means that an increasing number of customer financing over three times throughout in the last decade. The increase is in line with the increase in branch network of Islamic rural banks and ease the establishment of Islamic Rural banks by government. In the last ten years, there is an increasing number of Islamic rural banks Banks, from 105 become 163 banks and an increase in the number of service offices by approximately 4 times. The existence of the Financial Services Authority as a socializing institution banking helps to improve literacy levels in rural communities.

Third, Scope of Outreach. It referred to the types of financial contracts offered both products of funding and financing. More diverse types of financing facilities and more suited to the needs of the community, more better the outreach of Islamic Rural Banks. The name of products tailored to the needs of the community where Islamic Rural Bank located, but with legally skim contract and in accordance with the provisions of Bank Indonesia and the National Sharia Board (DSN). Usually lending product is channeled into various contract schemes are like murabahah, mudaraba, musharaka, greetings, istishna, ijarah, qard and multi-service. The domination murabahah contract, around 79.59% from other contract types at a financing agreement composition due to the use of this more applicable, multi-purposed and lower risks.

Fourth, Worth of Outreach. This indicator is defined as the willingness of customers to pay for financing. Outreach will be better when accompanied with the repayment ability of the community. Observations at the last 10 years shows that the ratio of NPF (Non Performing Financing) reached an average of 7,32%. It indicates that the bad financing in Islamic Rural Banks is quite high. Central Bank of Indonesia suggests this indicator at 5%. The issue of bad financing in Islamics Rural banks has become common issues that caused by internal or external causative factors. The limitations of human resource capacity in the

analysis of the feasibility of financing, the lack of monitoring and technology is often blamed to be the causes of internal financing problems in the Islamic Rural Bank. While the issue of moral hazard customers, side streaming in using of funds, and the limited ability of customers to manage Reviews their business are an external causes of the emergence of financing problems.

Fifth, Cost of Outreach. Its defined as the costs are paid by the customer as the margin rate and other transaction costs. More higher the price will be more lower the outreach. The fee charged by Islamic Rural Bank against society is quite high when compared to other financial institutions that served microfinance. The average rate of equivalent rate of return of Islamic Rural Banks in the last ten years (2006-2015) showed an average of 19.56% for murabaha financing, 20.93% for mudharaba financing and 18.49% for musyaraka financing. The level of the average rate of return looks much higher than the financial institution that offers microfinance. Its imply the inefficiencies in the operation and the higher of acquisition price for depositor funds.

Sixth, Length of Outreach. This is the time frame of micro-finance deals, which is not only measured by profit. However profit is one proxy for measuring the length of outreach. The higher and more stable profit, more better the outreach of financial institutions. It can be seen through the increase of Islamic Rural Banks's profit significantly by 23.14% in the last ten-year period. One issue that arises from the activities of Islamic Rural Banks is increasing in ratio of Operating Costs Operating Income (BOPO Ratio), the ratio of operating expenses incurred to generate operating income. The high operational cost at least the same as the operating income, will not be profitable for the Islamic Rural Bank. According to Central Bank of regulation, this limitation ratio is 90%. This ratio in Islamic Rural Bank around 88.09%, and there is the rising trend in the last ten years. Several things that can be the causes of this increasing is the increasing in operational costs for the expanding banks, high operating cost for micro-financing feasibility analysis and the high value of Non Performing Financing (NPF) encourage for high operating costs.

Increasing in office and network of Islamic Rural banks, increasing in accessibility of Small Micro Enterprises (SMEs), customer oriented banking services and social justiced concept, and also diversification of products, not necessarily able to be an indicator of financial inclusion program has been created an optimal condition in rural areas. Reinforcement on some of the things required by the Islamic Rural Banks in optimizing its function and purpose. Some strengthening strategies needed for Indonesian context are : *First; Strengthening the Regulatory Strategy.* The early stages of a proper banking development is the existence of regulations that provide guidance in a proper implementation strategy for development of Islamic Rural Banks. There should be a clear rules that support Rural Bank as a financial institution which has specific characteristics as a community bank and has a comparative advantage compared to the other Islamic financial institutions. Monetary authorities, in this case is Central Bank of Indonesia and the Financial Services Authority (OJK), actually have a development blueprint of Rural Banks. It is focused on strengthening the capacity of the industry through the capital, sustainability of Rural Banks, increasing the range and quality of service (OJK. Booklet of Indonesian Banking 2004. Ed 1 . March 2014 p.59). However, the regulation must necessarily be given for the application of some of the amenities that encourage the development of the Islamic Rural Banks as community banks. Regulatory limitations on some problem, sometimes make the Islamic Rural Bank not independent as a community banks, but as "an extended agent"of Commercial Banks's marketing where the Rural Banks deposits their account. Furthermore, the Islamic Rural Banks even compete with Islamic Commercial Banks which offering sub-branches, cash offices or sales outlet in the Islamic Rural Banks's operational area. *Second; Strengthening Strategy of Socialization.* Islamic Rural Bank's socialization related to all the effort in

building of public understanding about the presence of Islamic Rural Bank, this institution is more than just a village bank. Islamic banking tagline "beyond banking" built well as an effort to present Islamic Banking more than just "a bank", but the bank with the concept of social justice inside. Islamic Rural Banks declared since beginning as a community bank because of the Islamic Rural Banks is expected to have a comparative advantage which make them distinguish from commercial banks. Islamic Rural Banks role in supporting the development of local areas (community development), for being the closest financial institution for the productive sector, especially SMEs. As a community bank, Islamic Rural Banks is a kind of financial institution that understands the characters, the business needs of the community and have the products and services that are designed according to the needs of the community around it. *Third; Strengthening Competitiveness.* Some strengthening of competitiveness intended Islamic Rural Bank has competitiveness in terms of service, the level of competitive rate of margin and the professionalism in the management of banks. The Efforts to increase this competitiveness has begun intensively conducted by Bank Indonesia since 2010 which includes some of the following: a) Policy e-banking services, which are tailored to the size and complexity of the Islamic Rural Banks b) Improving of Good Corporate Governance, and c) Development of infrastructure of Islamic Rural Banks. *Fourth; Strengthening The Human Resources Aspect.* Strengthening human resources in Islamic Rural Banks identical to the implementation of Good Corporate Governance. In order to improve quality and the standart of human resources in Islamic Rural Banks, Bank Indonesia has made some improvement measures such as: the provision of fit and proper test in selecting the owner and manager of Islamic Rural Banks, certification programs and facilitate the improvement of skills and knowledge through training. Once again, a classic step such as increasing in the training budget is something that must be done.

4. Conclusion and Recommendation

The contribution of Islamic Rural Banks in realizing financial inclusion has existed before the concept of financial inclusion become popular, since Islamic Rural Banks is a type of financial institution that has been carrying since the beginning the function as a "community bank" and exist in rural Indonesia. The existence of Islamic Rural of course also showed great contribution in realizing this financial inclusion and the harmonization between real sector and monetary sector. Empirical evaluation of some facts about the outreach - social benefit- of Islamic Rural Bank showed the outreach of Islamic rural banks have already increased in four aspect: depth, breadth, scope and length. However, there is no a good performance for aspect worth and cost. The limitations of human resource capacity, the lack of monitoring and technology, customers moral hazard, side-streaming of fund, and the limitation of managerial business of customers are the causes of the emergence of financing problems. The issue of efficiency and high cost of funding contributed for the poor performance of outreach. In line with the expansion of the banking sector that is increasingly apparent, Islamic Rural Banks required the optimization efforts at various things that include strengthening the regulatory strategy, strengthening the promotional strategy, strengthening competitiveness and strengthening the aspects of human resources. Strengthening of the external and internal aspects of the Islamic Rural Banks will guarantee the implementation of reliable community banks and capable of supporting community development in rural area.

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