Lender of the Last Resort of Islamic Microfinance Institutions

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Abstract: As a financial intermediary institution, Islamic Microfinance Institutions (IMFI), that are known as Islamic Financial Cooperatives, accepts short-term deposits and disburses to long-term loans. This situation makes IMFI desperately need a lender of last resort (LOLR). So far, there has been no LOLR for Indonesian IMFI, so they formed its own LOLR. This study aims to find out how IMFI formed LOLR and find the best LOLR model for IMFI in Indonesia. This study use a qualitative approach with case study analysis. Subjects of this study are IMFIs in Indonesia that selected purposively with 30 managers as key informants. Triangulation of sources and techniques are used to confirm and test the veracity of the information. The results show that there are four models of LOLR of IMFIs; individual, other IMFIs, Islamic bank, and Islamic secondary cooperatives. The best model of LOLR is secondary cooperatives, because the form of IMFIs in Indonesia are primary cooperatives. Some primary cooperatives build a secondary cooperative as LOLR and places excess liquidity. All members of secondary cooperatives have deposit as reserve requirement on Central Bank in banking industry.

1 INTRODUCTION

Islamic Microfinance Institutions (IMFI) growing rapidly in Indonesia. Since it was first established in 1990, in 2016 the number reached 6,051 (Absindo, 2017). The name used vary, such as *Baitul Maal wa Tamwil* (BMT), *baitul tamwil*, Islamic cooperative, Islamic financial services cooperatives (KJKS), and the Credit Unions and Islamic Financing (KSPPS). However, over 98% of Islamic microfinance institutions used cooperatives institution as legal entities (Bank Indonesia and LPEI, 2011).

Islamic Microfinance institutions (IMFI) are intermediary institution in the micro sector with Islamic law principles. As an intermediary institution, IMFI faces liquidity mismatch. IMFI obtains short-term funds and releases them in the form of long-term credit. It makes makes them inherently vulnerable to liquidity risk (BCBS, 2008).

Liquidity risk is defined as the potential loss arising from the inability of financial institutions to fulfill obligations (Dusuki, 2007; Greuning and Bratanovic, 1999). This risk occurs when depositors collectively decide to withdraw their funds in an amount greater than the funds owned (Hubbard, 2002). For intermediary financial institutions, liquidity risk is the inability to meet short-term obligations.

Factors that cause intermediary financial institutions experiencing liquidity risk is the mismatch between the nature of funding short-term and long-term loans. In addition, liquidity and profitability is trade off for intermediary institution. When financial institutions want huge profits by channeling most of their funds, the liquidity decreased. Conversely, if the financial institution providing substantial funds to maintain liquidity, the funds are rotated decreased so that profitability also declined.

As an intermediary, IMFI also facing these two things. Moreover, as an Islamic intermediary institution, IMFI also face unique characteristics, both in terms of funding and financing. In terms of funding, most of the deposits using mudarabah contract that included an uncertain contract. On the financing side, IMFI using various contracts, each of which has unique characteristics. It makes IMFI face the possibility of a large liquidity crisis.

The inability of IMFI to pay its obligations will make depositors do not believe and withdraw their funds so that there is a rush. If it happens, IMFI will collaps. It could also effect other IMFIs and causing liquidity shock in the IMFI industry.

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To avoid a liquidity shock, IMFI requires the lender of last resort (LOLR) like the institutional banking intermediation. LoLR is the provision of a loan facility to IMFI experiencing liquidity problem and serves to avert a systemic financial crisis on the industry. Differences with the banks, the government did not provide lender of the last resort for IMFI. Therefore, IMFI establishes itself LoLR as a step to avoid the failure to pay obligations, particularly payments to depositors who withdraw funds at any time. This study aimed to identify the form of LoLR of IMFI in Indonesia. In addition, also found suitable models for IMFI's LoLR in Indonesia in the form of Islamic cooperative.

2 LITERATURE REVIEW

2.1 Islamic Microfinance Institution

More than 98% of IMFI in Indonesia operated as Islamic cooperatives, pursuant to Rule Minister of Cooperatives and SMEs No. 16 in 2015. IMFI is a cooperative that runs savings, loan, and financing with Islamic pattern which is called Credit Unions and Islamic Financing (KSPPS). IMFI is a intermediary institutions, ie receiving deposits and disbursing financing with Islamic Shariah compliance covenants only to members of the cooperative. Additionally, as a business organization that is also social institutions, IMFIs can receive and distribute zakat, sadaqah and infaq, as well as manage the waqf property. IMFIs in Indonesia adopted the concept of the *Baitul Maal wa tamwil*, which as a business institution (*baitul tamwil*) and social institutions (*Baitul Maal*) (Hamdan, 2009).

According to the Ministry of Cooperatives and SMEs, the number of IMFIs in Indonesia was 3,307 in 2010 with assets of Rp 3.6 trillion. In 2015, the number of IMFIs has increased to more than 5,000 with assets of more than Rp 4.7 trillion, and increase 6.000 in 2016. Most IMFIs have many branches to provide services to members and the community in various villages and towns (Hasbi, 2015).

Microfinance is financing institution that includes many types of financial services, one of which is microcredit. Microcredit is the type of loans given to customers with medium-scale enterprises and is likely to have never been in touch with the world of banking. Customers of micro-loans often do not have anything to serve as collateral, does not have a fixed income, and administrative requirements needed to access a loan of this type tend to be easier. Easily create customers from more middle-class people accessing these loans, so the amount of confidence that microfinance is a very important strategy for poverty alleviation.

Increasing people's understanding of Islamic law which forbids usury and allows the sharing system, as well as the saturation of the conventional financial system calculation of the profit on the flowers, are among the reasons that encourage people to use the Islamic system the profit calculation is based on the bond for the results.

Based on (Muttaqien, 2013) explaination, the Islamic economic system not only regulates the technical seek profit but also serves a basic philosophical outlook in the context of the human economic activity. The presence of Islamic Micro Finance Institutions (BMT, USPPS or KSPPS) is to be appreciated, because according to (Alam, 2012) where IMFI basically complement the financial institution that is able to serve all segments of Indonesian society.

According to Law No. 25 in 1992, the cooperative is a business entity consisting of persons or legal entities with the bases cooperative activities based on the principle of cooperation as well as people's economic movement based on family principles. Swasono in (Hendar and Kusnadi, 2005) explains some reasons for the cooperative to become the backbone of the Indonesian economy.

Cooperative is a container accommodating the political message that the poor economic colonized and dominated by the colonial economic system. Cooperative realize mutual interests, help themselves collectively to improve the welfare and productive capabilities. Cooperatives are appropriate container to build a small economic group (native). The small economic group is not a problem partial macro issues in the economic life of Indonesia, both in quality and quantity.

2.2 Lender of the Last Resort

Concepts Lender Of The Last Resort according to Law No. 3 of 2004, the Central Bank is a state institution that has the authority to issue legal tender of a country, to formulate and implement monetary policy, regulate and maintain the flow of payment system, regulate and supervise the banking system and running the function of lender of last resort. Bank Indonesia in carrying out the functions of lender of last resort to give credit or financing based on Islamic principles to banks experiencing short-term liquidity problems caused by the mismatch in fund management. The loans provided by Bank Indonesia to banks that need it for a period of maximum 90 days. In addition, requirement provided by Bank Indonesia to the receiving bank is a bank loan the borrower is required to provide high-quality collateral, the collateral must be liquefied with the minimal collateral value equal to the loan amount.

Particularly financial institutions such as Islamic microfinance institutions (IMFI) are vulnerable to liquidity problems, namely the ability of financial institutions to meet the obligations of customers who save or borrow. is motivated by the liquidity problem not match the time between customers save money and borrowed funds, customers tend to save money in a relatively short time span while customers who apply for loans in Islamic microfinance institutions have a long period. Lender Policies Of The Last Resort (LoLR) is the key to these problems because LoLR proved to be one effective tool in the prevention and crisis management.

In principle, LoLR divided into two conditions, namely: 1) Normal LoLR loans from the one financial institution temporary to the other that have liquidity problems but do not have a systemic impact, the receiving loans should also provide adequate collateral with a minimum value of the loans. Normal LoLR aims to keep the payment system and monetary stability remain smooth and stable. 2) LoLR crisis is a loan provided a financial institution that is experiencing a shortage of liquidity, and could cause systemic risk to the entire financial system. Potential systemic impact factor primary consideration in awarding LoLR to a crisis, this LoLRinstitution guarantee given to the less and unable to pay debts, but no warranty is given by the government. LoLRinstitution can provide emergency financing to commercial funding borne dby the government.

2.3 Liquidity

Based on (Brigham and Houston, 2001) explaination the liquidity ratio is a ratio showing the relationship of cash and other liquid assets with short-term liabilities. A company can be said to be liquid if the company is able to pay off its short-term financial obligations or long-term liabilities maturing during the year. Meanwhile, if a company is not able to pay off their financial obligations then categorized into companies that are illiquid.

According to (Riyanto, 2001), the factors to be considered in determining the liquidity can be divided into three parts as follows. First, The amount of investment in fixed assets compared with the rest of long-term funds. Second, The volume of corporate activities. Third, Control current assets.

In theory, liquidity risk management (LRM) can be analyzed from the balance sheet (assets and liabilities) and LRM policies (Ismal, 2010). On the asset side, the LRM analysis takes into account the efforts of Islamic financial intermediation institutions in monitoring financing; Arranging the right allocation of financing; Standardize financing; How to deal with financing in poor economic conditions; And how the intermediary financial institutions handle liquidity shortages (Akhtar et al., 2011).

In the context of an intermediary institution, liquidity risk occurs in two cases. First, it appears symmetrically to the debtor in relation to the intermediary institution, for example when the intermediary institution decides to stop the credit, but the debtor cannot afford it. Secondly, it appears in the context of bank relations with depositors, for example when depositors decide to withdraw their deposits but the intermediary institutions cannot afford them (Greenbaum and Thakor, 2007).

In other words, good liquidity management shows good Sharia implementation as well. Sharia implementation is a good consequence for Sharia financial institutions that will get closer to the achievement of the goal of Sharia, the *maslahah* (Chapra, 2001).

However, as previous explanation related to how important LoTR of Islamic microfinance, has not been found research that addresses that institution. the studies that have been done more to discuss the Islamic bank, such as research conducted by (Aldoseri and Worthington, 2009; Ben et al., 2014). Risk of liquidity of microfinance institutions is something urgent that need to answer, and this research be expected can give useful solution.

3 METHODOLOGY

This study use case study analysis. The Subjects are Islamic Microfinance (IMFI) that known as Islamic cooperatives in East Java selected purposively with managers and co-manager of IMFI as key informants. Triangulation of sources and techniques are used to confirm and test the veracity of the information.

Data mining is done in several stages. Data mining is an effort to dig deeper into the information as long as it has not yet been realized by many parties from a data. The first is through a Focus Group Discussion (FGD) with the IMFI managers, representatives from the Department of Cooperatives of government, and a companion which is Microfin. FGD is done to look for a variety of important elements in determining the lender of last rsort (LOLR) of IMFI. In addition, the FGD is also aimed at obtaining information on LOLR models of IMFIs which are different to one another. Once the elements of the LOLR model is set, then the data mining done by interviewing managers of IMFI indicated to have different LOLR. The second stage is a process where we are realize that there are four models of LOLR of IMFIs; individual, other IMFIs, Islamic bank, and Islamic secondary cooperatives. At the last stage, the researchers found that the best model of LOLR is secondary cooperatives, because the form of IMFIs in Indonesia are primary cooperatives.

The data analysis techniques of this research is using content analysis method. Content analysis method is defined as a technique to draw conclusions by identifying specific characteristics of a message in an objective, systematic, and generalist (Holsti, 1969). This method is intended to analyze the whole discussion about the BMT's LOLR.

4 RESULTS AND DISCUSSION

Islamic Microfinance Institution (IMFI) is a financial intermediary institution. IMFI receives deposits from third parties that surplus funds, then distribute it to parties who need funds (deficit). The short-term nature of deposits and long-term financing make IMFIs often face liquidity problem. Most of the 128 IMFIs being questioned, all claimed to have liquidity problem experienced.

According to the managers of IMFIs, liquidity problem can be anticipated. Therefore, liquidity problem can be predicted when it occurs. The main cause of liquidity problem by IMFI is the commemoration of religious holidays such as Ramadhan and Idul Fitri, new school year, and planting season. This is as revealed by Nyakdin, director of IMFI Hero Tulungagung, "Historical data about customer behavior is an important lesson in regulating liquidity.

The importance of liquidity is well understood by IMFIs. Abdul Madjid Umar, director of IMFIs UGT Sidogiri which is the largest IMFIs in Indonesia said, as an intermediary institution, liquidity regulating is very important for IMFIs. Therefore, liquidity is the pulse of intermediary financial institutions, so that if fails to regulate liquidity, then the future of IMFIs business will be destroyed.

Liquidity is a trade off of profitability. If liquidity is good, then generally profitability is disrupted, and vice versa, if profitability is good, liquidity is threatened. Because, to maintain liquidity, IMFIs need to reserve a certain amount of funds so that if at any time taken by the depositors, the IMFIs will have no liquidity problem. However, the reserve fund is idle, so it cannot be used to make profit.

It is known that 82 of 128 IMFIs (64%) claim to be able to solve their own liquidity problems. IMFIs that can overcome their own liquidity rely on customer deposits to overcome liquidity (35 of 46 IMFIs). In addition, linkage with other financial institutions, either linkage with sharia banks, linkage with other IMFIs or other financial institutions. Some IMFIs rely on multiple sources at once.

From this fact, it appears that linkage becomes very important for IMFIs. If they cannot rely on customer deposits to cope with the usually urgent liquidity, then they rely more on linkage with Islamic financial institutions. During this time, most of IMFIs in East Java is already doing linkage with Sharia banks. Meanwhile, IMFIs that can not cope with their own liquidity, 48% rely on ownership capital (first rank), from other IMFIs (13%), from government (13%), and from personal bank loans.

IMFIs who can solve their own liquidity perform productivity improvement measures (36%), internal process optimization (32%), and productivity improvement (32%).These three are quite effective in overcoming liquidity independently. Generally, those who do this are IMFIs who are experienced in performing their intermediary function, so they already know when liquidity difficulties will occur, such as before Idul Fitri, new school year, and planting season for farmers.

Activities in addressing the need for liquidity independently is very diverse. In optimizing the internal process, the way in which is done is to reduce the financing (40%) and increase the capital (53%), while the efficiency step is done by reducing the operational cost (51%) and the optimization of working hours. While in improving productivity, which is done to improve employee performance (47%) and billing (45%).

From this study, it is known that IMFI requires a lender of last resort to obtain short-term loans. With the loan, IMFI can pay its obligations, so the trust of depositor will be maintained. As a result, there is no withdrawal of large amounts of funds that could result in IMFI experiencing liquidity difficulties.

There are four models of lender of last resort of IMFI. Firstly, IMFI established a formal guarantor institution in the form of a secondary cooperative which consists of IMFI, namely the Center for Sharia Cooperatives. In East Java, there are five secondary sharia cooperatives. This secondary cooperative consists of institutions, namely the primary Islamic cooperatives. Primary IMFIs that lack liquidity can obtain liquidity from secondary co-operatives. Likewise, the primary cooperative IMFIs that excess liquidity can place funds on secondary cooperatives.

Thus, the Secondary Cooperative becomes a lender of last resort for the IMFI. “ "We set up a secondary cooperative, recognizing the importance of places to place excess liquidity or otherwise seek funding when liquidity shortages," said Nyakdin, director of BMT Pahlawan in Tulungagung.

IMFIs Pahlawan with 39 other BMTs in Tulungagung, Blitar, and Trenggalek districts form a secondary sharia cooperative named Center for Sharia Cooperatives (Puskopsyah). In addition, 40 BMTs affiliated with the Indonesian Islamic Da'wah Institution (LDII) form a secondary cooperative IMFIs. Similarly 40 IMFIs under Aisiyah Muhammadiyah East Java form a secondary cooperative Bueka As-sakinah East Java.

Secondly, IMFIs takes the financing of a stand by loan at a sharia bank that can be taken at any time when liquidity difficulties occured. In general, IMFIs have assets and are bankable so it is easy to take financing in sharia banks. In fact, many IMFIs have linkage with sharia banks not only in case of liquidity difficulties, but also to enlarge the reach of financing.

This is done by BMT UGT Sidogiri, BMT Maslahah Sidogiri Pasuruan, BMT Mandiri Sejahtera Gresik.

Third, establishing non-formal inter-IMFI relations or other financial institution. IMFIs that are in one region generally have a close relationship that can help each other. Likewise, IMFIs are affiliated in an organization's ties, such as Muhammadiyah, Nahdhatul Ulama, and the Indonesian Islamic Da'wah Institution (LDII). Therefore, they usually form non-formal relationships to help each other when needed, including in overcoming the lack of liquidity or vice versa.

Forth, have individual backing that can be borrowed at any time. This step is usually done by IMFIs with relatively small assets. Usually, people who can lend IMFIs still have business relationships, such as customers or administrators. When they face liquidity problem, management borrows short-term funds from them.

5 CONCLUSIONS

As financial intermediary, IMFIs face liquidity problem. Most IMFIs can solve liquidity problems by relying on customer deposits to overcome their liquidity, linkage with other financial institutions, linkage with sharia banks, and other IMFIs. IMFIs that cannot cope with their own liquidity rely on ownership capital, from other IMFIs, government, and Islamic or personal bank loans. IMFIs that can solve their own liquidity difficulties take productivity improvement measures, internal process optimization, and increased productivity. These three things are quite effective in overcoming liquidity difficulties independently.

To solve the lack of liquidity, IMFIs make a lender of last resort. There are four models of IMFIs’s lender of last resort. First, the IMFIs established a formal guarantor institution in the form of a secondary cooperative. Secondly, IMFIs cooperates with Sharia bank by opening a stand-by loan which can be taken at any time when facing liquidity problem. Third, establishing non-formal inter-financial institution relations. Fourth, have individual backing that can be borrowed at any time. The best models of lender of last resort is a secondary cooperative.

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