
Obstacles and Solutions in Performing Islamic Financial Contracts

(A Case Study of *Bayt al-Maal wa al-Tamweel*[BMT] UGT "Sidogiri", East Java)

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Abstract

There are some obstacles faced by Islamic microfinance institutions in performing Islamic financial contracts as purely demanded by Islamic law. In case of Bayt al-Maal wa al-Tamweel (BMT), the application of Islamic financial contracts needs a special approach and innovation. By taking BMT Sidogiri of East Java as the researchsite, this study qualitatively evaluated the practice of murabahah, mudlarabah, and musharakah contracts conducted by such an institution. In examining these obstacles, this study had conducted several in-depth interviews with the branch manager of BMT Sidogiri of Malang City. The findings revealed that the obstacles in performing Islamic financial contracts are dominated by lack of knowledge, asymmetric information, limited cooperation among related institutions, opportunistic behavior, and lack of social capital. To overcome these obstacles, it is recommended that the practices of Islamic financial transactions were not only in line with shari'ah-compliant but also with shari'ah-based schemes.

Keywords:

*BMT Sidogiri,
Islamic financial
contracts, obstacles,
solutions*

INTRODUCTION

After the enactment of Law no. 21/2008, Islamic finance institutions increasingly show their existence in Indonesia's financial industry. Until August 2016, 11 Islamic commercial banks have been established, and 23 Islamic banking units are spreading in 2564 offices across the country. Alongside this, Islamic Rural Banks also grew to 163 BPRS with 439 offices. While Islamic commercial banks work in the area to finance large businesses, BPRS serve to finance small communities, especially micro, small and medium entrepreneurs (Sudrajat, 2014).

In addition to these Islamic finance institutions, *Bayt al-Maal wa al-Tamweel* (BMT) emerged as an Islamic microfinance institution that obtained the legality from the Ministry of Cooperatives and SMEs. As their legality is not ruled under the banking law, the characteristics of BMT in the economic development are more flexible than Islamic banks or BPRS. Unfortunately, the number of BMTs on the national stage has been not known exactly (Sakti, 2013) but Masyithoh (2014) noted that by 2013 the number of BMTs has reached more than 5500 units with assets ranging from hundreds of millions to trillions of rupiah.

The most dominant financing applied in Islamic finance institutions is *murabahah* and *musharakah* which is based on the principle of profit sharing. In August 2016 *musharakah* financing grew 19% from 14.9% in the previous year, whereas *murabahah* financing grew 9.6% increased 13.3% in the previous year. The increasingly trend of *musyarakah* financing in August 2016 showed a slowly transition from revenue sharing to profit and loss sharing. Hence, the performance of Islamic finance institutions has been influenced by the amount of financing disbursement and composition which is at the same time become the main source of profit (Sutrisno, 2016).

Meanwhile, BMT occupies a unique position for its dual functions in serving Islamic financing as well as social services. One of the fast growing BMT in Indonesia is BMT UGT Sidogiri, began operating on 5 Rabiul Awal 1421 H / June 6, 2000 M in Surabaya and then get a Cooperative Law agency from the Regional Office with SK Number: 09/BH/KWK.13/VII/ 2000 in July 22, 2000.

Every year BMT Sidogiri initiates several units of service

members in districts/ cities that are considered potential, and currently this institution manages 278 branch offices spread all over Indonesia. It is noted that BMT Sidogiri's assets until 2016 are IDR2.2 trillion, growing by about 41 percent from Rp 1.509 trillion in 2014. Then, a turnover of IDR16.9 trillion was listed in 2016. In addition to its development, BMT Sidogiri accommodated a membership of 16,010 people in 2016 increased almost twice compared to 8,871 people in 2013. People who trusted to save their money in BMT UGT Sidogiri as much as 783, 418 people, and customers who get financing is noted 137, 981 people.

However, the operationalization of BMT Sidogiri as stipulated by the Islamic jurisprudence still faces many obstacles. Among the main obstacles is related to the implementation of Islamic financing contracts that are not fully in accordance with the provisions of Islamic law. This paper is intended to reveal the obstacles in the implementation of Islamic financial contract and solutions taken by BMT Sidogiri for solving this problem. Related to this is also a question whether Islamic finance institutions should perform *shari'ah-compliant* or *shariahbased* will get the answer.

LITERATURE REVIEW

Previous studies on Islamic finance institutions (IFIs) revealed that IFIs have developed tremendously. Nowadays, IFIs covered more than 50 countries including countries of Europe, CIS, USA, and Australia (Tatiana et. el, 2015). While in Indonesia, IFIs succeeded to record their quantitative performance in profit growth, assets, and the number of branch office. However, in some extent the practice of Islamic financial contracts face some obstacles to be implemented purely and needs certain solutions.

Islamic Financial Contract

Islamic financial contracts have been applied on the basis of three fundamental principles, they are: there is no *riba*, free from heavy uncertainty (*gharar*), and preventing from gambling transactions (*maysir*). Moreover, Islamic financial contracts are also developed on the principle of justice and partnerships (Siddiqui, 2008). On the discussion of *riba* whether it is found in Islamic financial products or not, it must be specified whether there is *interest rate* but *noriba* inside so as to the Islamic financial

contracts must be characterized as *free riba contract not interest free contract* (Suharto, 2018).

In IFIs, the position of Islamic contracts is very essential since law and Islamic finance are stated as a set of contract (Ismail and Tohirin, 2009). In this term, a contract is defined as "the conjunction of an offer emanating from one of the two contracting parties with the acceptance of the other in the manner that affects the subject matter of the contract". To name in specific terms, there are various of contracts, i.e. contract of sales and purchases, contract of usufructs, contract of sharecropping, partnerships, and equity participation (Shafiai and Moi, 2015). For more general practices, the most common of Islamic financial contracts are: *murabahah*, *ijarah*, *musharakah*, and *mudlarabah* (Tatiana et. al., 2015).

According to Dalel and Bessem (2013) *murabahah* is a contract of sale with profit. In this contract, customer gives an order to an Islamic finance institution to purchase certain good, on its behalf, in cash. The customer then takes this good through a deferred payment with a margin paid to the institution which can be done once or several deadlines.

Meanwhile, *ijarah* is a leasing contract. It is basically a leasing arrangement in which the capital owner as financier rents the required assets, property or services to the customer. For this service the financier imposed certain fee for the period of the rental contract (Nazirwan, 2015).

For partnership contracts, Aljifri and Khandenwal (2013) defined *musharaka* as partnership relation in which both parties have right to participate in management. Profit and loss emerged from the contract are shared proportionally to both parties. Meanwhile, *mudlaraba* is partnership relation in which financing partner does not participate in management but has access to information.

Agency Theory Perspective

According to Shamsuddin and Ismail (2013) agency theory or the principal-agent relationship is a theory in which a contract allows one or more persons to perform some services on their behalf which involve delegating some decision-making to the agent. In IFIs, the unit of analysis is the contract between the principal and the agent for the specific contract terms is analysed to determine the effect of the agency problem. In this regard,

principal tends to motivate agents to perform appropriate actions to his or her remuneration (Aljifri and Khandelwal, 2013).

The problem emerged from the principal-agent relationship might be caused by two things. *Firstly*, the problem arise when the principal and agent have different objectives, and *secondly*, when the principal feels some difficulties in accessing accurate information and behaviour of the agent (Shamsuddin and Ismail, 2013). In another form, Syawaluddin et. el (2016) pointed out two problems namely problem of hidden action and of hidden information. For the problem of hidden action the principal cannot take an action on what is done by the agent, while for the problem of hidden information the principal has less information than the agent.

Since BMT uniqely operates as Islamic community-based institution, a close relation-ship between the principal and the agent is very essential. *Amanah* among the two parties, therefore, becomes a compulsory requirement for the success of Islamic financial contracts practiced by BMT.

Shari'ah-Compliant vs Shari'ah-Based Scheme

The current issues on Islamic financial practices are whether Islamic finance institutions have conducted purely with Islamic jurisprudence or not. Some leading scholars classified such issues as either *Shari'ah-compliant* or *Shari'ah-based*. The first is Islamic financial products that mimic their conventional counterparts with certain changes for the sake to satisfy religious sensitivities. Whereas the second is Islamic financial products that strictly follow the real spirit of the *Shari'ah* (Hasan, 2014).

These issues might be caused by a misleading perception among critics that percieved Islamic finance institutions as charitable institutions and expect them to do more social work than commercial activities (Lone and Ahmad, 2017). In fact, Islamic finance institutions are the intermediary institutions that take care of investor's expectations. One of the expectations is that the institutions must provide profit to the investors.

Concerning the current practice of Islamic finance institutions, such an issue is still debatable. However, it is interesting to provide Hasan's opinion (2014) that views *shari'ah-compliant* as "manifestation" whereas *shari'ah-based* as "intention". Performing Islamic law in financial transactions takes manifestation as evidence of intention. Allah alone knows

what intention guides each of the parties involved in the implementation of Islamic financial contracts.

RESEARCH METHOD

This study was conducted on *Bayt al-Maal wa al-Tamweel* (BMT) UGT Sidogiri. Located at the center of traditional market "Jodipan", Jl. Kebalen Wetan No. 1 Malang City, BMT Sidogiri provides Islamic financial services to small traders of the market. Among others, BMT Sidogiri is the biggest Islamic microfinance institution in East Java and in national level as well. The information was based on several interviews with Mr. Junaidi, the Branch Manager of BMT Sidogiri. He is very experienced individual with wide knowledge on Islamic financial contracts and directly involved in the activity and product development of BMT UGT Sidogiri.

During November-December 2017, appointments were made for in-depth interview with Mr. Junaidi. Interviews were carried out in the workplace and voice recorder was used to record all information provided by the informant. This research conducted two times interviews and each of the interviews took one hour and half (90 minutes). Copies of transcripts of all recorded conversations are in the attachment. As primary data source, the interviews were conducted to gather a general idea of Islamic microfinance practices especially those are taken from the experiences of BMT Sidogiri operations. After all the interviews had been fully transcribed, the thematic analysis was performed to describe some obstacles in performing Islamic financial contracts and the solutions taken by BMT Sidogiri for overcoming such obstacles.

RESULTS AND DISCUSSION

Based on the interview and in-depth review of the transcripts, several obstacles and solutions in performing Islamic financial contracts are highlighted. Principally, Islamic contracts in financial transactions combined ethical facts, material facts, information, and condition forms as an integral part of the legal contract (Aljifri and Khandelwal, 2013). In reality, nevertheless, it is very difficult to purely implement the Islamic contracts for several reasons. This paper discussed obstacles and solutions for *murabahah* and for *musharakah-mudlarabah* contracts as follows.

Obstacles and Solutions in *Murabahah* Contract

i. *Customer Ignorance*

The principle difference in Islamic contracts is not fully understood by most people. It is often found that the use of Islamic terminologies such as loans and financing or interest and margin are interchangeable merely caused by customers' confusion and ignorance. However, the problem of customer ignorance on Islamic financial practices has been also faced by another country. In Tunisia, for example, Bougatef et. al (2012) showed that 65% of respondents stated that they ignored the concept of Islamic finance and its principles.

This problem, of course, will give certain disadvantage for practicing Islamic finance purely. To solve this problem, BMT UGT Sidogiri then introduced two work standards how the institution applies its financial transactions. *First*, the practice of Islamic contract must be based on the principle of validity. This means that all contracts that become the operational basis of BMT must be legitimated by Islamic law. All contracts must be reconciled through *fiqh* proofs so there is no doubt in their application. And *secondly*, Islamic financial contracts must be easily applied.

The public's ignorance about Islamic financial contracts is further elaborated by the informant as follows:

"We are in the application of the contract is putting forward the side of the legitimacy that ease our members to understand...this is because for over thirty years our society has been entrapped conventionally." When we introduce the Islamic contract they think it is the same as conventional ".

ii. *The Dominance of Conventional Finance*

The introduction of *murabahah* schemes to replace the interest-bearing loan contract is not easy. This is due to the community's understanding of conventional financial practices is still so strong that it has not been able to distinguish the consequences of the loan and *murabahah* loan contracts. People still see the similarities between the two contracts. According to Hanif (2011) the major perception in muslim society on the domination of conventional financial practices remains becomes a specific barrier to implement Islamic financial schemes.

Therefore, BMT Sidogiri tried to explain these Islamic contracts in ways that are easily understood by the public. One way in doingso is to implement the contract in the forms of *bilwafa*, *tashili*, and *istighlal* contracts as described by the informant as follows:

“Among them is *akad bilwafa*, *tashili* and *bay al-wafar*, that is buying and selling with a promise to buy back .. after the item was bought then we make agreement again named *akad bi al-istighlal*”.

In principle, the contracts are implemented so that the BMT's business earned a profit but not by way of imposition of interest on the loan. In this case the operating income is obtained by way of imposition of rent on goods sold in a certain time. For example there are customers who come to BMT ask to be financed the purchase of a motorcycle. Meet the needs of these customers, BMT then come to the dealer shows a motorcycle to customers with a purchase price of IDR20 million. This motorcycle is then sold to customers at a price of IDR22.5 million so that BMT get a margin of IDR2.5 million is regarded as *ujrah* on motorcycle rental. Within an agreed period of time, the customer then settled the price of the motorcycle.

As profit to be obtained, the BMT set the *ujrah* amount of the financing of goods given to the customer. Even so, the customer can actually also negotiate the amount of *ujrah* in accordance with their ability. If the agreement has been reached, the customer then fulfilled the installment obligation on the agreed price of the goods as well as the *ujrah*. Here, we see that the innovation from *murabahah* to *ijarah* is a solution taken by BMT to reduce the improper understanding of loan interest and *murabahah* margin.

iii. Lack of Cooperation between Related Institutions

The socialization of Islamic finance contracts is constrained by the lack of cooperation with the parties that should be concerned to minimize the ignorance of the public in *halal* transaction. For example is the explanation can also be provided by the *ustad*, *mubaligh* and *kyai* who are able to help the acceptance of Islamic financial contracts to be more popular in the community. *Dakwah* material should not only be related to *ubudiyah* but also *muammalat* which actually covers a large

part of Muslims' activities. The success in disseminating Islamic contract is perceived to accelerate the progress of Islamic financial business which in turn it reduces the dominance of *ribawi* financial system:

“The obstacles are.. only our employees who know the contracts without any help from others; like from our ustad, preachers....they only prioritize the explanation of the *ubudiyah* side ... and the two are difficult sometimes sometimes just so-so just mask ... just wrote his name aja *sharia*”.

iv. Asymmetric Information

The lack of public knowledge about Islamic finance is also caused by inappropriate information. The assumption that the financing in BMT is expensive with a convoluted procedure is actually caused by people's reluctance to find the right information. Another cause is the deeds of some customers who have problems with BMT then the person spread the word that is not true about BMT. Some customers have problems in fulfilling their obligations to BMT, for example in terms of delayed repayment of installments, but then fabricate stories that credited the BMT. The informant described this asymmetric information problem as follows:

“Because they do not know sometimes just hear from people who have problems with us ... let's say BMT problem is not smooth then he because the sense of not happy continue to disseminate to others.”

Thus, information that is not symmetrical greatly affected the acceptance or rejection of the community of Islamic financial contracts offered by BMT. Especially in this case is if the ignorance of the community is sharpened by the news that cornering BMT will make it more difficult for the spread of Islamic finance institutions to run the Islamic principles of business.

To overcome this problem, BMT Sidogiri imposed *murabahah* contract followed by *wadiah* (savings) agreement. In this contract, the *murabahah* is intended to finance the needs of customers with a sale and purchase scheme so that BMT obtained certain benefits for the institution's income. Meanwhile, the customer has an obligation with a certain ratio

to pay off installments of *murabahah* financing. Then, looking at the habits of the micro traders who are less thorough in financial management, BMT offered saving programs for customers that is operated on the basis of *wadiah* agreement. So, every month customers need to do two things; 1) pay *murabahah* installments and 2) save their money.

The nature of this saving is of course voluntary action, but this actually has many benefits. *First*, savings will add to customers' wealth without counting every day. By saving the customer is trained to be careful in managing their money. *Second*, the routine in saving can be used as an indicator to assess customers' cash flow. And *third*, the saving also serves as a backup for customers in *murabahah* installment when a customer has no money or forgot to pay their monthly installment.

Such systems have in fact facilitated small traders to carry out *murabahah* schemes in an easy and practical way. *First*, traders are now beginning to understand the implementation of Islamic financial contracts without studying about it carefully. Most of their time is spent on trading so it is not possible to read the tenets of Islamic law in buying and selling. And *second*, the saving program created an easier way for traders and BMT to settle the obligations and consequences of *murabahah* financing. Through the system of installments and saving, BMT will easily control the customers' cash flow so as to can calculate the possibility of customers default. If the saving record is current then this indicates that the customer will be able to settle the installment obligation smoothly too. The opposite condition can happen if the customer is not fluent in saving their money.

v. Competition with the Bank

Nowadays, the microfinance industry turns out to show a tight level of competition. The players in this industry are no longer met by microfinance institutions but also by large banks. This narrow market niche by itself is quite troublesome for BMT Sidogiri so it takes a variety of tactics in order to get a profit that encourages the growth of BMT business.

At first glance, we assume that big banks will be easy to reap many customers. Due to large capital owned, large banks certainly do not weigh on lending to small traders. In this area, competition can be imagined to be won by big banks while microfinance institutions such as BMT Sidogiri will bear the

loss and close their business.

However, in a competitive situation with this large bank, BMT Sidogiri establishes strategic steps in the form of flexible financing services. The informant explained about this as follows:

“When there are two institutions of the same job, then the winner is for the best service And we’re different, if in banking it is indeed more exclusive nature. They emphasize the formalities of banking itself, but we apply our operations more flexibly.”

Applying flexible service is possible for BMT since its nature is actually not banking institution. Although in practice BMT Sidogiri serves as a micro finance institution but its legal entity as cooperative enables it to work flexibly. In addition, BMT Sidogiri also has a social mission of poverty eradication which encourages it to approach society more intensively but with persuasive and easy ways. For example, some formal requirements set by banks are handled in a way that is not so formal by BMT Sidogiri so that the convenience and flexibility of this service can be accessed by every small trader.

In this context it seems BMT Sidogiri has been able to get its own place in the hearts of market traders. It is evidenced that the number of market traders who become customers of BMT Sidogiri continues to grow even though the big banks are also actively providing credit for the needs of the traders’ business. Nevertheless, understanding the community about Islamic contracts still requires considerable patience because the customers always make a comparison between BMT Sidogiri and the bank.

Particularly in this case is the comparison of transaction fees set to become one of the attention of the customer to choose the services provided by the bank or BMT Sidogiri. Customers are always looking for transaction costs that are perceived cheaper without thinking about *halal* transaction contract. Therefore, the convenience and flexibility of BMT Sidogiri as much as possible also leads to reduction of transaction costs for customers. Viewed from the social function of BMT, the intension to get cheaper transaction costs than the bank is actually a reasonable demand. This especially will encourage BMT Sidogiri to balance the business functions and social functions so that the goal to socialize Islamic contracts will be able to manifest quickly.

vi. Imperfect Contract

As the legal *istinbath* in *fiqh*, financial transactions using *murabahah* schemes should meet the terms and conditions of this contract. In practice, however, the pillar of *murabahah* can not always be fully realized, especially in relation to the possession of goods which are subject to BMT. Straightforward criticism usually refers to BMT behavior that actually reflects only the intermediary in the transaction and not the owner of the goods.

Critics assume that the practice of this kind of *murbahah* is not said to be in accordance with the Shari'a as idealized. However, providing a stock of goods poses a business risk. According to informantts, BMT Sidogiri does not provide stock of goods caused by two considerations. First, the provision of stock of goods is feared to interfere with the smooth flow of cash when the goods are only piled unsold. And secondly, the small traders of Jodipan market have so many and varied needs that it will be difficult to provide their new stock:

“Stock of commodity ... It's actually we are a bit choked too pack because the needs of our customers are different.”

Considering these reasons, BMT Sidogiri chose to implement *murabahah* schemes without having to provide stock of goods as a mark of BMT ownership of goods. As an example in motorcycle financing, BMT Sidogiri does the same pattern for financing other goods that are needed by customers. That is, for every financing of goods needed by customers, BMT officers will invite customers to go to the seller of such goods and then *murabahah* transactions carried out in that place as well. As mentioned earlier, the practice of such a *murabahah* gets much criticism and is perceived by society as a financial transaction that is not different from conventional ways.

Moreover, *murabahah* is then modified by introducing a transaction contract that is easy to implement called as *rahn tasjili*. It was stated in this contract that BMT Sidogiri buy goods which are then leased to customers with a certain *ujrah* as an advantage for BMT with the amount set by BMT Sidogiri. For example, motorcycle purchased by BMT for IDR15 million then handed over to customers with *rahn tasjili*. For this BMT Sidogiri set *ujrah* for IDR200.000 per month for 2 years. With this contract the customer was required to pay the motorcycle to BMT Sidogiri IDR19.8 million with details of IDR15.000.000

as the purchase price and IDR4.800.000 as BMT's *ujrah* for two years.

Obstacles and Solutions in Partnership Contracts

i. Limitation of Business Scope

The limited target of BMT Sidogiri's business for micro and small traders only becomes an important cause why *mudlarabah* and *musharaka* contracts were not easy to implement. It is true that BMT Sidogiri basically focuses only on small scale transaction finance transaction program that serves small transaction value. We then understand, when BMT Sidogiri focused on micro and small traders it will face limited capacity of the traders that is only short-term spin so they may not need stocks for developing their business. In this case, the customers do not need investment financing facilitated by *mudlarabah* and *musyarakah* contracts. Therefore, *mudlarabah* and *musharaka* in the financing performance of BMT Sidogiri is only distributed in a small portion of financing as explained by the informant as follows:

"Formudlarabah-musyarakah...this actually we are not so much usually we make it easier and stress to our members to better understand its contract because *mudlarabah* basically is a bit difficult application."

Because the business partners faced by BMT Sidogiri are merely micro and small traders, the operationalization of BMT is mostly based on *murabahah* and *rahn tasjili* transactions. For daily business, the merchants basically only need a help for fulfillment of working capital that may be insufficient for investment capital. On the other hand, BMT Sidogiri itself try develop its business on the basis of cooperation scheme smoothly for obtaining a definite profit. Hence, a way to innovate the contract from *mudlarabah torahn tasjili* gives more assurance for both parties. For BMT Sidogiri this contract gives them a definite *ujrah* received every month while for traders this contract facilitates them an easy procedure.

Following *mudlarabah*, it is stated in this contract that *mudlarabah* determined agree-ment in terms of revenue and loss sharing. If the cooperation between BMT Sidogiri and market traders earn a profit then each will get its share in accordance with the agreement. Whereas if such cooperation brings losses then BMT Sidogiri must bear this loss as long as the loss is caused by

natural considerations in business risk. This contract seemingly give a burdensome for BMT Sidogiri so as to clearly requires the openness among both parties. In this regard, customers' openness is demonstrated by a good accounting record so that BMT Sidogiri can read the business development of its customers. Good bookkeeping is also a means of control so that customers do not deceive BMT by giving wrong information. For example the customer informs that he is losing money when in fact he gets a high profit. Such matters are due to the prevailing general presumption that in the contract of cooperation everything will be borne by BMT:

"It could also be a risk if *mudlarabah* contract was in improper implementation to the BMT...we are worry if they give wrong information, for example they get profit five million but say five hundred thousand only...no proof... but, when something wrong happens during this cooperation we must bear the risk."

ii. Opportunistic Behavior

The impact of the absence of good bookkeeping is that small traders as BMT's customers behave without a planned business size. Trafficking or buying and selling is undertaken and sometimes traders think to act only selfishly. The mercurial rationality of merchant-driven traders can lead to other opportunistic behaviors that may not in accordance with Islamic law.

One of the opportunistic behavior of BMT's customer is a consideration to choose a cheaper financing among financial institutions. They will compare whether the financing from BMT Sidogiri is cheaper than other financial institutions or not. Nevertheless, BMT Sidogiri officers never give an explanation of the importance of Islamic contract until they fully understand:

"Sometimes they are cheaper orientation just because they do not understand it so we give them explanations."

In the application of *mudlarabah* contract, for example, it is perceived that this contract can encourage more sustainable investment because cooperation is based on the calculation of profit and loss sharing, not on the basis of unilateral consideration of capital owner as applied in conventional financial institution. It is also clear that if this business cooperation can generate profits then the profit will be divided in accordance with the

agreed ratio and if it gets a loss then the BMT Sidogiri also share the loss. Even if the loss occurs naturally it drives BMT to bear it fully as determined by Islamic law. Such provisions are clearly not found in con-ventional financial institutions as these institutions usually has established a special mechanism that protected them from various forms of loss.

The emergence of opportunistic behavior among customers actually encourages BMT Sidogiri to make some breakthroughs that facilitate and ease the traders. In this regard, BMT Sidogiri strives to make some efficiencies in its financing so that it is more affordable by customers. However, depending on the level of risk of the project Yousfi (2013) stated that *mudlarabah* contract actually can reduce client's opportunism. This is because, *mudlarabah* can lead the institution and the entrepreneur to provide their first best level of efforts.

iii. Lack of Social Capital

Financial business basically requires a high degree of trust between the parties involved. Especially in *mudlarabah* and *musharakah* transactions, mutual trust between BMT Sidogiri *asshohib al-mal* and small traders as *mudlarib* becomes absolutely necessary. Thus, trust is a social capital that is indispensable for good and successful application of partnership contracts.

During eight years of interacting with small traders in the Jodipan market, BMT Sidogiri felt that to apply *mudlarabah* and *musharaka* contracts required high social capital from the traders. Especially the honesty of traders become the absolute requirement in rolling *mudlarabah* funds that the results in this contract cannot be predicted with certainty. This means that during the bonding period both parties can notensure the gains or losses that are avoided. This is certainly very different from the system of interest that gives certainty for the owner of the money (bank) to not lose money.

Therefore, BMT Sidogiri requires the honesty of customers when they want to apply for investment financing with *mudlarabah* scheme. Basically this requirement can be done well if the customer has a proper accounting record so that through this bookkeeping BMT Sidogiri can estimate customer honesty through the smoothness of their cash flow. Nevertheless, BMT Sidogiri feels that society now is different in terms of business honesty:

“Yes as it...one is honesty.....sometimes the community itself is different, today society is different from our society in the past.....”.

iv. Limited Knowledge Capacity

Basically BMT Sidogiri is a micro finance institution covered by the rules of Islamic law. The operational objectives of BMT Sidogiri are thus directed to channel microfinance into society activities, especially micro and small traders. Within this situation, the operationalization of BMT Sidogiri was ultimately limited by a specific market share, in contrast to the market share held by the banking sector. Meanwhile, the rules *muammalat* are various with detailed descriptions requiring a correct understanding of the small traders. This is different from the contracts in the bank which is only one type for all forms of transactions, namely the loan agreement flowering.

Thus, viewed from the aspect of community literacy on Islamic contracts, there has been a gap in the application of *mudlarabah* contract to small traders. This situation ultimately led BMT Sidogiri to act rationally by targeting market traders to what they can understand. For example, the customers are directed to use the contract of *rahn tasjili* rather than *mudlarabah*, even though *mudlarabah* contract is more rewarding for BMT Sidogiri.

Due to a lack of knowledge capacity, *mudlarabah* contract was often constrained in its application. This situation drives BMT Sidogiri to further expanded the business with various Islamic contracts that encourage customers' business. The informant explained this as follows:

“Our market target is different...people who enter the bank are educated people, at least they can read and write. While people who enter our office are not all educated people. Even, they commonly cannot read and write well.”

Hence, it can be understood that to perform *mudlarabah* and *musharaka* is rather difficult for BMT Sidogiri. This is different from Islamic banks that generally have customers who are well-educated. Even many of the customers of Islamic bank are able to make a sophisticated book keeping or predict business trends. By having educated customers, it certainly allows Islamic bank to introduce *mudlarabah* and *musharaka* contracts easily.

Nevertheless, Islamic banks also face the same problem in customizing *mudlarabah* and *musharaka* contracts. The problem of opportunistic behavior cannot be solved easily so that Islamic banks are required to always streamline with heavy financing to customers. Therefore it is commonly found from the performance reports of Islamic banks that the portion of *mudlarabah* and *musyarakah* enjoyed smaller portion compared to *murabahah*. The greater portion of *murabahah* clearly indicated consumption financing, whereas one of the main objectives of the establishment of Islamic banks is to create and grow the productive capacity of society through cooperation contracts, i.e. *mudlarabah* and *musharaka*.

Recognizing such complex issues in *mudlarabah* application, BMT Sidogiri finally declared to return to its *khittah* as microfinance institution, that is to provide working capital for micro and small businesses. However, the application of Islamic contracts need to be done with caution because the greater the financing is given the greater the risk will be accepted by BMT Sidogiri:

“We go back to *khittah* means let the big financing is covered by the bank...and we back to the micro business, because the greater the financing the greater the risk as well.”

CONCLUSION

The objective of Islamic financial contracts is not only based on the profit pursuit, but also to meet the ethico-socio-economic objectives. Islamic law has provided rules and regulations on how to meet these objectives when BMT Sidogiri implements its financial products developed from the basis of Islamic jurisprudence.

In reality, however, practicing these Islamic contracts is not easy. BMT Sidogiri must face many obstacles when the institution introduces Islamic financial services to society, especially small traders in Jodipan market. Lack of knowledge, lack of social capital, asymmetric information, and opportunistic behavior are among dominant obstacles that must be overcome. Some solutions such as innovate the contracts, flexible procedures, door to door services, and *dakwah* to society are taken for addressing the obstacles.

Facing these conditions, implementing Islamic financial

contracts that are in line with *shari'ah* compliance remains a *necessary* condition for BMT's products to be Islamic in form. To complete the contracts in practice, however, BMT Sidogiri must fulfill the products *insufficiency* condition of being *Shari'ah*-based in substance.

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