

ISLAMIC CAPITAL MARKET AND DEBT FINANCING OF *SHARIAH*-COMPLIANT FIRMS IN INDONESIA

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Abstract

Islamic Capital Market (ICM) is expanding rapidly worldwide and Indonesia is following very closely. Examining 290 shariah-compliant Indonesian firms, we found that certain firm and industry level determinants do influence the debt financing without ignoring the shariah principles governing the decisions. The ICM accelerating growth is very much reflected in the findings, thus contributing significantly in the literature and to the policymakers as well. Being shariah-compliant does not hinder them from engaging in higher debt with Islamic debt instruments employed as alternatives.

Keywords: Islamic Capital Market, Islamic Finance, Debt Financing, *shariah*-compliant, Indonesia

Introduction

Recent literature is witnessing constant reference to and particular attention to Islamic Finance, particularly on *shariah*-compliant firms and investments due to its accelerating growth and massive untapped potential to the economic world. What distinguishes the *shariah*-compliant firms with the conventional ones is that *shariah*-compliant firms are governed by certain rules and regulations set by *shariah* principles. The *shariah* law prohibits any core activities related to *riba* (interest), especially in any financial services, *gharar* (uncertainty) like in conventional insurance and *maysir* (gambling). The prohibition also includes any activities related to non-*halal* products, share trading in non-*shariah*-compliant securities and other activities that are not in harmony with *shariah* principles.¹

In order to identify these *shariah*-compliant firms, Islamic indices are established. These indices screen stocks and sort out firms with activities contrasting *shariah* principles.² Since the first debut of Islamic finance indices in 1998 by Swiss-based Faisal Finance and Bank Vontobel, which was then known as DMI 150 (Dar al Mal al-Islami), the huge potential of Islamic Finance was then recognized by the giant stock markets from the developed market, the Dow Jones with the inception of the Dow Jones Islamic Market Index (DJIMI) in February, 1999 and the Financial Times Stock Exchange (FTSE) with its Global Islamic Index Series (GIIS) in October, 1999.³ Looking at the emerging markets in the Southeast Asia region, two huge Muslim population countries which are Malaysia and Indonesia, both have their Islamic indices known as the Kuala Lumpur Stock Exchange *Shariah* Index (KLSI) and the Jakarta Islamic Index (JII) respectively.

For the stocks to become *shariah*-compliant, stocks must go through certain screening processes. Firstly the stocks must be

¹ R. Haron and K. Ibrahim, "Target Capital Structure and Speed of Adjustment: Panel Data Evidence on Malaysia Shariah Compliant Securities." *International Journal of Economics, Management and Accounting*, 20 (2012), 92.

² M. Rifqi "The Cost of Sharia Investing: Comparative Empirical Study in Indonesian Stock Market." *Journal of Emerging Economies and Islamic Research*, 4 (1). (2016), 4.

³ *Ibid.*, 5.

screened on their activities, to ensure that they do not engage in prohibited activities mentioned earlier, and secondly, stocks must be screened on their debt ratio to ensure non-excessive engagement with conventional debt which normally bears *riba*.⁴ With the massive untapped potential of Islamic Finance, particularly the increasing potential of *shariah*-compliant firms in this region, bearing the status as an emerging economy in Southeast Asia and the largest population of 255 million people with 210 million (82 percent) being Muslims and with its recent growth in its Islamic Banking assets, Indonesia is believed to stand on a strong foundation to become a global player in Islamic finance,⁵ Indonesia's Financial Services Authority (*Otoritas Jasa Keuangan/OJK*) puts forth various efforts in promoting Indonesia's Islamic Finance and aims to increase the Islamic Finance industry from 4.88 percent share of Indonesia's total banking and finance market currently to 15 percent by 2023.⁶ The OJK has declared 2015 to be the year of *shariah*-compliant capital market in order to increase understanding and awareness with a road map designed to guide the development of Indonesia's Islamic capital market for the next five years (The Report: Indonesia 2015).

The Indonesian Islamic banking assets' compounded annual growth rate (CAGR) of 29.2 percent between 2010 and 2014 gives confidence to the possibility of achieving the vision of 15 percent market share by 2023.⁷ The Indonesia Stock Exchange offers 311 listed *shariah*-compliant stocks (based on Daftar Efek *Shariah*, OJK as at May 2016) to potential investors with Jakarta Islamic Index of 30 *shariah*-compliant stocks as the market benchmark. One of the elements in Islamic capital market (ICM) is *sukuk* and The Jakarta Stock Exchange sees a rapid growth in *sukuk* trading over the years. The Indonesian government plans to issue about IDR 13.7 trillion (approximately USD \$1.4 billion) worth of *sukuk* in 2016, highlighting its confidence in the market.⁸

⁴ M. A. El-Gamal, *Islamic Finance: Law, Economics, and Practice*. (Cambridge University Press, 2006), 4.

⁵ Gates K & L "Indonesia's Next Steps in Islamic Finance," *Legal Insight*, (March 2016), 1.

⁶ Clyde & Co. "Islamic Finance in Indonesia," (June 2016), 2.

⁷ Gate K&L, "Indonesia's Next Steps..." 1.

⁸ Clyde & Co. "Islamic Finance..." 2.

In response to the rapid growth of Indonesian ICM and the encouraging development of the *shariah*-compliant securities being one of the main attractions and focus on the Indonesian ICM, the objective of this study is to examine the financing choices of these *shariah*-compliant firms and investigate the factors affecting the financing choices. Despite the phenomenal growth of ICM in this region, study on the debt financing decision of *shariah*-compliant firms and its determining factors is very much lacking specifically in Indonesia; hence, this study intends to fill the gap in the literature. By examining 290 listed *shariah*-compliant Indonesian firms with the duration from 2000 to 2014 using panel data regression (Pooled Ordinary Least Square (OLS), the Fixed Effect and the Random Effect), we study the determinants of the debt financing decision of these firms which include firm level as well as industry level determinants.

To the best of our knowledge none of the existing studies on *shariah*-compliant firms has included industry effects as determining factors to debt financing; thus this study contributes significantly and distinguishes itself from the rest of the studies. Simerly and Li argue that the debt financing decision of a firm can be influenced by the characteristics of an industry and may have effects on firm value.⁹ Therefore, this study incorporates three industry level determinants which are industry dynamism, industry munificence and industry concentration or the Herfindahl–Hirshman Index (HHI). Kayo and Kimura explain that industry dynamism refers to the volatility or shocks in the industry, whereas the munificence relates with the effect of abundant resources in an industry.¹⁰ This study will also relate the findings with the theories of debt financing, the trade-off (TOT), the pecking order (POT) and the agency theories and see whether these theories can be extended to and are able to explain the financing choices of *shariah*-compliant firms in Indonesia, despite the *shariah* principles governing these firms.

⁹ R. L. Simerly and M. Li, “Environmental Dynamism, Capital Structure and Performance: A Theoretical Integration and an Empirical Test,” *Strategic Management Journal*, 21 (1), (2000).

¹⁰ E. K. Kayo and H. Kimura, “Hierarchical Determinants of Capital Structure,” *Journal of Banking and Finance*, 35 (1), (2011), 359.

The rest of the study is composed as follows: it will look at a brief history of Islamic Finance in Indonesia, a brief explanation on debt financing literature and the determinants incorporated in this study. Then it will examine the data and methodology employed in this study--the findings, analyses and discussions--and the final section concludes the study.

Islamic Stock Market in Indonesia

The Jakarta Islamic Index (JII) is responsible for measuring the performance of Islamic stock markets in Indonesia. Established on the 2nd of July 2000, the JII consists of 30 stocks satisfying several criteria established by the Capital Market Supervisory Agency and Financial Institution (Bapepam).¹¹ In 2003, the National *Shariah* Board (DSN) of Majelis Ulama Indonesia issued a *fatwa* on capital markets and general guidelines for the implementation of *shariah* principles where firms shall meet the core business criteria (qualitative) and the financial ratios criteria (quantitative) in order for their stocks to be classified in the JII group. The core business criterion assesses the firms' activity which does not interfere with prohibited activities as discussed earlier. Meanwhile, the financial ratios criteria deal with the limit for debt ratio, accounts receivables to total assets and interest income to revenue which requires upper limits of 45%, 55% and 10% respectively.¹²

The JII is responsible in providing a venue for investors who wish to invest their funds according to Islamic principles and is expected to increase investors' confidence in developing Islamic equity investments. Based on the data from Bapepam, the performance of JII indicates significant growth. JII's monthly closing value has grown from 537.031 points in December 2011 to 746.872 points in August 2016.¹³

¹¹ E. Listyaningsih and C. Krishnamurti, "How Performance of Jakarta Islamic Index (JII) Stocks Relative to Other Stocks?" *Jurnal Dinamika Manajemen*, 6 (2), (2015), 147.

¹² I. Wahyudi and G. A. Sani, "Interdependence between Islamic Capital Market and Money Market: Evidence from Indonesia." *Borsa Istanbul Review*, 14 (1), (2014), 34.

¹³ Daftar Efek Syariah, Otoritas Jasa Keuangan, accessed 2016,