Understanding Sustainability and Outreach of Islamic Charity Based Microfinance: Case Study in Indonesia

by

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Submitted in fulfilment of the requirements for the degree of

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Lists of publications associated with this thesis

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## Glossary

<table>
<thead>
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<th>Term</th>
<th>Definition</th>
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<tbody>
<tr>
<td>Amil</td>
<td>An individual who manages the collection and distribution of zakat funds and other Islamic charitable funds</td>
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<tr>
<td>Arisan</td>
<td>An informal microfinance mechanism similar to rotation credit and savings association</td>
</tr>
<tr>
<td>As sabiyah</td>
<td>A concept of team work, brotherhood, cooperation and trust among members of a group</td>
</tr>
<tr>
<td>Bai' al Muajjal</td>
<td>A feature of a sales contract where payment for the required asset is deferred to a future date</td>
</tr>
<tr>
<td>Baitul maal</td>
<td>The social unit of an Islamic financial cooperative, that manages the collection and distribution of Islamic charitable funds</td>
</tr>
<tr>
<td>Baitul Tamwil</td>
<td>An Islamic financial cooperative that offers small-scale financial products using an Islamic transaction schemes in local areas</td>
</tr>
<tr>
<td>BAZ</td>
<td>Badan Amil Zakat: a government owned zakat organization</td>
</tr>
<tr>
<td>BAZNAS</td>
<td>Badan Amil Zakat Nasional: a national government owned zakat organization. The top authority of zakat institutions in Indonesia</td>
</tr>
<tr>
<td>BMMI</td>
<td>Baitul maal Muamalat Indonesia</td>
</tr>
<tr>
<td>BMT</td>
<td>Baitul maal wat tamwil: an Islamic financial cooperative that manages both social and commercial functions within the organization</td>
</tr>
<tr>
<td>BQB</td>
<td>Baitul Qiradh BAZNAS: a department of BAZNAS that focuses on microfinance and economic empowerment programs</td>
</tr>
<tr>
<td>CGAP</td>
<td>Consultative Group to Assist the Poor: a division of the World Bank focusing on the advancement of the microfinance sector</td>
</tr>
<tr>
<td>Gharar</td>
<td>Entering into a contract that involves a high level of risk and uncertain outcomes. For example, gambling, contracting to sell unborn, or in utero lambs, and any transactions related to financial derivative products</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Definition</td>
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<tr>
<td>ICBM</td>
<td>Islamic Charity Based Microfinance: a microfinance provider that uses Islamic charity as a source of microfinance funding</td>
</tr>
<tr>
<td>Ijarah</td>
<td>A contract between a bank and a client, whereby the bank purchases and leases out equipment required by its clients for a rental fee</td>
</tr>
<tr>
<td>Infaq</td>
<td>A specific purpose of charitable donation</td>
</tr>
<tr>
<td>KUMMM</td>
<td>A BMIM microfinance conducted through the local mosque</td>
</tr>
<tr>
<td>LAZ</td>
<td>Lembaga Amil Zakat: a privately owned zakat institution</td>
</tr>
<tr>
<td>MFI</td>
<td>A microfinance institution</td>
</tr>
<tr>
<td>Mudharabah</td>
<td>A partnership between two parties: banks as the investors provide 100% of the capital with borrowers providing entrepreneurial project management skills. Profits are shared between the bank and its borrowers with all losses borne by the bank</td>
</tr>
<tr>
<td>MUI</td>
<td>The organization of Indonesian Muslim scholars</td>
</tr>
<tr>
<td>Murabahah</td>
<td>Reselling an asset at a marked up price by the lender to the borrower on a signed contract</td>
</tr>
<tr>
<td>Mustahik</td>
<td>Eligible zakat recipients which include eight recipient categories</td>
</tr>
<tr>
<td>Musyarakah</td>
<td>A situation in which two or more parties share the capital and expertise of managing an enterprise with profits and losses shared based on the amount of capital each party invested.</td>
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<tr>
<td>Muzakki</td>
<td>A zakat donor</td>
</tr>
<tr>
<td>Nadzir</td>
<td>An individual who manages waqf funding</td>
</tr>
<tr>
<td>Nisab</td>
<td>The threshold amount of wealth that is obligated to pay zakat</td>
</tr>
<tr>
<td>Qard hassan</td>
<td>A benevolent loan that has to be repaid at the end of an agreed period at a similar amount to the loan principal</td>
</tr>
<tr>
<td>Riba</td>
<td>An additional predetermined amount that debtors have to pay over and above the loan principal</td>
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<tr>
<td>Shadaqa</td>
<td>A charitable donation made to those in need in order to seek a blessing from God</td>
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<tr>
<td>Term</td>
<td>Definition</td>
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<tr>
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<tr>
<td>Tamlik</td>
<td>A concept of transfer of ownership of an asset given by a zakat donor to a zakat recipient</td>
</tr>
<tr>
<td>Wadiah</td>
<td>Safekeeping for deposits</td>
</tr>
<tr>
<td>Waqf</td>
<td>A long term form of shadaqa that involves withholding and preserving certain physical assets for the long term benefit of society</td>
</tr>
<tr>
<td>Zakat</td>
<td>The pre-determined share of wealth prescribed by God to be distributed among deserving recipients according to their specific recipient category</td>
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Abstract

Islamic charity has been suggested as an important source of funding to enhance the achievement of microfinance’s double bottom line: sustainability and outreach. It offers a continual stream of funds that can be utilized to meet the financial needs of the poorest as well as to significantly reduce the financial costs involved in offering microfinance. This thesis examines the nexus between Islamic charity and microfinance. It tests the proposition that microfinance will achieve a sustainable bottom line and be more inclusive of poor members of society if Islamic charity is used as a funding source.

The research methodology employs a case study approach. Three institutions were selected to represent the diversity of the Islamic charity based microfinance (ICBM) providers in Indonesia: BAZNAS representing the government owned zakat institution, BMMMI representing a private owned zakat organization and Baitul Maal Beringharjo representing the social unit of Islamic financial cooperatives. Primary data was collected during the fieldwork stage carried out from 2011 to 2012 in Jakarta and Yogjakarta. In this study, 270 respondents completed questionnaires and nine managers and staff were interviewed. Secondary data was obtained from the participating institutions’ reports, government publications and microfinance institutional data published by an independent microfinance consultant. The data was analyzed using both qualitative and quantitative methods, and employed a general inductive approach, descriptive analysis, poverty analysis and a binomial logit model.

The first research question examined the extent to which sustainability was achieved. In this study, sustainability was defined as the ability of the institution to continuously provide services to its constituents. The study found that existing providers of ICBM adopted innovative strategies for fundraising and product development and managed to encourage institutions to be more accountable for achieving defined sustainability. In particular, the study findings suggest that local institutions have a greater ability to gain community support than national coverage institutions. Additionally, it found that institutions that are highly dependent on Islamic compulsory charity, known as zakat, face more challenges in relation to sharia compliance and public perception that may limit an institution’s operating
budget, create a low rate of repayment, and hence reduce the institutions’ capacity to continuously deliver microfinance.

The second question examined the extent to which outreach was achieved, where ‘outreach’ is defined as the ability of the institution to effectively target the poor for inclusion in the program. The study found that existing ICBM programs have been specifically designed to meet the needs of the poor as they have provided both financial and non-financial services to the clients. However, such programs failed to attract the participation of the poor and the poorer members of the society. The study findings suggest that ICBM clients are the vulnerable who live just above the national poverty line. This thesis argues that institutions’ inability to attract the participation of the poor may be caused by inadequate program promotional strategies, selection policies that unintentionally exclude the poor, and by particular cultural values related to a future orientation and patriarchy.

Drawing on the findings generated in this study, the thesis proposes that ICBM should not provide financial services directly to the poor due to the complexity involved in addressing the constraints of zakat, while at the same time, meeting the objectives of microfinance. In this case, the study findings suggest ICBM institutions should play a role as a preparatory institution that builds the capacity of the poor to enhance their participation in microfinance. This thesis strongly suggests the inclusion of ICBM in the broader social and economic agenda to enhance the inclusion of society’s poor in the financial system and as a possible consequence, go some way to alleviate poverty in Indonesia.
Chapter 1

Introduction

1.1. Research background

This thesis examines the nexus between Islamic charity and microfinance. It will consider the proposition that microfinance has a greater chance of being sustainable and more inclusive of the poorest members of society if Islamic charity is used as a significant source of funding. This thesis will test this proposition through the use of case studies of three Islamic charity based microfinance (ICBM) institutions in Indonesia.

Islamic charity is significant in Indonesia, being approximately 3.4% of the national GDP in 2010 (Firdaus et al., 2012). It is estimated that approximately one-third of funds collected by Islamic charity institution during the period of 2004 to 2008 is distributed through mechanisms that enable the poor to gain long term benefits from the charity such as improved access to education and training and to economic empowerment programs (IRTI, 2014).

Despite the availability of Islamic charity, poverty and financial exclusion is still widespread in Indonesia. Although the poverty rate has been steadily decreasing from 23.4% in 1999 to 12.5% in 2011, more than 40% of the country’s population is categorized as financially vulnerable and exists on the edge of poverty (The World Bank, 2012b). Of this financially vulnerable sector, less than half have access to financial services (Bank Indonesia, 2013). Existing providers of microfinance only target a specific segment of the population and as such may fail to provide financial services to poor clients (Nugroho, 2010). It is documented that 99% of micro entrepreneurs have no access to financial services (MKUKM, 2012). Islamic charity has been suggested as a potential source of funds to increase financial inclusion and to provide financial access to the micro entrepreneurs who currently have limited access to financial services (Mohieldien et al., 2011). To what extent and how Islamic charity can be utilized in microfinance will be explored theoretically and empirically in this study.
The long history and current active presence of Islamic charity and microfinance in Indonesia, as evidenced in the literature, supports a strong argument for conducting case study research of the relationships between Islamic charity and microfinance. Since the early 1980s, the use of Islamic charity for microfinance has been undertaken by Islamic financial cooperatives such as *Baitul maal wat tamwil* (BMT). Recently, there has been also increasing participation of zakat organizations in this sector due to the growth of Islamic charity collection. Traditionally, zakat funds in Indonesia are distributed directly to the poor. These funds are largely used for more personal consumption purposes. Although direct distribution still occurs, zakat distribution via institutions has been increasing since the 1960s (Abdullah, 1991). This thesis reports on research undertaken in both BMT and zakat organizations as institutional case study examples in order to better understand how Islamic charity can enhance institutional sustainability and increase the participation rate of poorer members of society in the microfinance program.

This chapter is structured as follows; Section 1.1 introduces the study; Section 1.2 presents the research problems and questions; Section 1.3 describes the methodological approaches and processes; Section 1.4 identifies the potential contributions of the study to the overall Islamic microfinance literature. Section 1.5 outlines the organization of the thesis; and the last section concludes the chapter.

1.2. Research problems

Unlike formal financial institutions, the success of microfinance should not only be evaluated solely on its financial performance, but also on its capacity to reach the poor and achieve financial sustainability (Brau, 2004, Rhyne, 1998). However, the strategy to achieve these goals appears to be a conflicting one. Achieving a particular level of financial performance, or financial sustainability, means finding strategies to reduce transaction costs, increase efficiency and achieve profitability (CGAP, 2006). In contrast, reaching a specific outreach means the institutions need to consider how to meet additional costs to provide an integrated approach of microfinance programs that are inclusive with other development interventions, such as health provision and skill training (Simanowitz and Walter, 2002a). It appears that the tensions around achieving
It is generally believed that providing the poor with access to financial resources requires high operational costs for distributing loans, for monitoring and for enforcing procedures. Small loans are generally considered to be too costly to administer and do not generate sufficient revenue for the institution (Ayayi and Sene, 2010). Therefore, continuing subsidies, in the form of low cost funding injections, may be necessary to enable institutions to achieve financial sustainability and to achieve more extensive outreach (Armendáriz and Morduch, 2005). However, the challenge seems to be that subsidies may not always be available, or easy to access. Dependency on subsidies was cited as one of the major constraints on the growth of microfinance (Ledgerwood, 1998). Alternatively, some microfinance institutions decide to adopt principles that charge commercial rates to the clients. The idea is that to reach a large number of clients, the institution has to be profitable and have access to various types of capital, including commercial capital (Robinson, 2001).

The application of commercial principles and the transformation from donor dependency into profit seeking institutions offers at least three key advantages. First, these commercial principles and dependency transformation allows the institution to access commercial capital and to reduce the possibility of a liquidity shortage. Second, it also encourages microfinance institutions to improve their product design, delivery system and outreach in response to the competition in the industry. Thirdly, it offers an institution greater opportunities to fulfill its social objectives of serving the poor by providing a greater range of financial services, including savings products that are considered important for the poor (Charinotenko, 2003). However, this commercial transformation may force institutions to shift their market focus in order to reduce their operational costs by serving more accessible clients and targeting less risky consumers (Zeller and Meyer, 2002). Consequently, a large number of the poorest of the poor can be excluded from accessing microfinance services as some microfinance institutions have shifted from their original mission of serving the poor (Morduch and Haley, 2002, Hashemi and Umaira, 2011).
The tradeoff between the objectives of achieving financial sustainability and reaching the poor has become evident in several cases (see Cull et al., 2007, Christen, 2000, Polanco, 2005). Rhyne (1998) argues that both objectives are complementary to each other with the achievement of sustainability being means to reach the institutions’ social objectives. Interestingly, currently there are growing discussions in the literature on how microfinance can return to its original mission in serving the poorest in a sustainable way (see Simanowitz and Walter, 2002b, Hashemi and Montesquieu, 2011). The literature shows that the financial performance of those microfinance institutions serving the poorest is equal to those not serving the poorest (Churchill, 2000, Gibbons and Meehan, 2000).

Islamic microfinance has been suggested as a model that can be financially viable and serve the poorest in the same time (Ahmed, 2002, Kaleem and Ahmed, 2009). Islamic microfinance is the application of Islamic finance principles to microfinance. The major difference between Islamic microfinance and conventional microfinance system is that Islamic microfinance does not charge clients a fixed interest rate, but applies particular Islamic finance schemes of transaction ranging from profit and loss sharing, sales contracts, lease contracts and charitable contracts (Dhumale and Sapcanin, 1998). Moreover, Islamic microfinance has the advantage of utilizing Islamic charity as an alternative source of funding for micro-lending (Obaidullah, 2008, Hassan, 2010).

The failure of microfinance to achieve its objectives is generally put down to three major problems: moral hazard, asymmetric information and financial problems (Ahmed, 2002). Current microfinance providers have significantly limited the problem of moral hazard through the implementation of group guarantee mechanisms as a substitute for physical collateral. Despite this effort, problems of asymmetric information and financial viability continue to exist. The asymmetric information problems occur when borrowers have better information than lenders. In microfinance contexts, the asymmetric information problem is frequently found in cases where funds are diverted from production purposes to consumption purposes. A diversion of funds results in a lower repayment rate by clients. Islamic microfinance options, as an alternative to conventional microfinance, limit this problem by utilizing Islamic charitable funding sources to take care of the basic needs of the poor (Obaidullah, 2008). The problem of a lack of
financial viability may be limited by reducing overall financial costs since Islamic charity is a low cost source of funding.

Ideologically, both Islamic charity and microfinance initiatives share similar underlying goals in relation to poverty reduction. The original motivation of microcredit programs was to provide the poor with financial services in the form of loans that could be used to assist the poor in lifting themselves out of poverty. Similarly, Islamic charity attempts to address broad ranging issues around income inequality and poverty through a distribution of wealth from the wealthy to those who find themselves in desperately poor financial circumstances (Bonner, 2005a, Jassemm, 2007). More importantly, the distribution of charity in an Islamic context is considered more meaningful if it is given for empowerment purposes rather than through a direct funds transfer. Empowerment purposes enable the poor to gain long term benefits from the charity. The similar underlying goals of both initiatives may allow microfinance and Islamic charity to work together to achieve the objectives of poverty alleviation.

Much of the literature reviewed emphasized the benefits of the use of Islamic charity over microfinance. Islamic charity has been seen as a low cost source of funding that can provide continual circulating liquidity to society (Mohiedien et al., 2011). However, there was little attention in the literature to the basic question of the nexus between Islamic charity and microfinance. It is a common understanding that Islamic charity is premised on a set of sharia rules and guidelines (Jassemm, 2007), thus its implementation has to ensure compliance with these religious rules and guidelines. These literature findings inform the first research question: To what extent can Islamic charity be used in microfinance without compromising the inherent characteristics of Islamic charity?

The use of Islamic charity influences the nature of products and services that the microfinance institution can offer to the society. Since institutional income is mainly generated from philanthropic sources, institutions that use Islamic charity for microfinance only offer charitable services to specific target clients. On this understanding, Islamic charity can be seen as a type of subsidy for microfinance. Subsidies certainly have an important role to play in microfinance. It is widely argued
that the success of the Grameen Bank is driven by donor subsidy (Armendáriz and Morduch, 2005). As another example, the microfinance program of Al Akhuwat in Pakistan is also sustainable even though it is fully dependent on charity (Khan, 2011). However, the notion of sustainability of fully subsidized institutions depended on religious charity has not been fully explored, either theoretically or empirically. The research reported in this thesis, therefore, asks the question: To what extent can ICBM institutions be sustainable?

In addition to the sustainability issue, the literature reviewed notes that one of the advantages of utilizing Islamic charity in microfinance initiatives is its ability to facilitate the participation the poorest of the poor in the microfinance program (Obaidullah, 2008, Ahmed, 2002). Islamic charity can be utilized to provide social development programs to more effectively address the various barriers that may constrain the participation of the poorest in microfinance. This theoretical assertion will be tested by asking the question: Is ICBM able to facilitate the poorest’s participation in microfinance?

With respect to the discussion above, the objectives of this study are:

1. To examine the characteristics of Islamic charity and microfinance that may both enhance and constrain the ability of microfinance to achieve institutional sustainability and outreach
2. To examine the institutional sustainability of ICBM
3. To examine the ability of ICBM to provide access to financial services for the poorest of the poor
4. To propose a new model of ICBM that embraces inclusionary practices in Indonesia derived from the findings on the first three objectives

This research study will attempt to achieve these objectives by considering case studies and utilizing both qualitative and quantitative data. Three ICBM institutions in Indonesia will be included in this study: BAZNAS, representing a government owned zakat organization, BMMI, representing private owned zakat organizations, and Baitul Maal Beringharjo (BMB) representing the social unit of financial cooperatives.
1.3. Research approach

Firstly, this study will review the literature on Islamic finance, microfinance and Islamic charity. Drawing on the literature review, this thesis will identify and examine the characteristics of Islamic charity and its appropriateness to microfinance. It will find that the various types of Islamic charity have different roles to perform in microfinance.

Then, this study will explore the theory on sustainability and outreach. The findings from the literature review will inform the development of a theoretical framework of sustainability and outreach in the context of ICBM. This framework is intended to be used as an interpretative tool in the data analysis process. The framework developed will be further explained in Chapter Three of this thesis.

The next approach is to select an appropriate methodology as an attempt to achieve the objectives of this study. In general, social phenomenon can be scrutinized by two approaches: an extensive and an intensive approach (Swanborn, 2010). An extensive approach requires a large data set that is used to establish a generalization of research finding. In contrast, an intensive approach provides in-depth understanding of a specific case. In microfinance literature, the evaluation of financial sustainability and outreach mostly employed an extensive approach of study that utilizes a large set of cross sectional data (see Cull et al., 2007, Polanco, 2005, Mersland and Strom, 2010). In some cases, an extensive approach, however may have limited capability in delineating specific problems faced by an institution (Swanborn, 2010).

This study will employ an intensive approach by using case study methodology as the overall research approach. According to Yin (2009a), case study is an appropriate methodology to investigate why a specific decision is undertaken and what are the results of such a decision. In this study, a case study approach enables the researcher to investigate the results of the decision to use Islamic charity as microfinance program’s source of funding: whether Islamic charity is able to enhance institutional sustainability, or able to increase participation of the poorest in the program. An explication of the research methodology and data analysis will described further in Chapter Four.
1.4. The significance of the study

The research reported in this thesis is located at the intersection of two areas of study: Islamic charity and microfinance. It is expected that the research findings presented in the thesis will contribute to knowledge and understanding of these areas in two key respects.

Firstly, the research findings will add to literature calls for increased empirical evidence of the benefits of utilizing Islamic charity in microfinance. The major studies, for example Obaidullah (2008), Hassan (2010), Kaleem and Ahmed (2009) provide theoretical discussions and develop various models to integrate Islamic charity and microfinance, whether these study findings are supported or not has however, yet to be explored. Empirical research studies are therefore needed to advance existing ICBM theory. In addition, issues around sharia compliance and effectiveness of Islamic charity as religious instruments in lending provision remain debatable in the literature (see Sarif and Kamri, 2009; Wan Ahmad and Mohamad, 2012). This study will contribute to the Islamic microfinance literature by showing empirical evidence of the sustainability and outreach of ICBM institutions in Indonesia.

Secondly, it is expected that the study will contribute to the further development of microfinance by providing an alternative microfinance model that may work in more efficient and effective ways for the poorest. The current discussions on microfinance development support the assertion that that microfinance has become more broadly inclusive by providing equitable financial access to all segments of the poor (Ledgerwood et al., 2013). Simanowitz and Walter (2002) argues that the poorest can be included in the program without jeopardizing the sustainability of the institution. Several ‘pro-poorest’ programs have been initiated, such as the poverty graduation model of the CGAP (Consultative Group to Assist the Poor) and the Ford foundation, the targeting of the ‘ultra-poor’ program (TUP) of BRAC, and the adoption of the Grameen model in CRESES and SHARE (Hashemi and Umaira, 2011, Simanowitz and Walter, 2002a, Hashemi and Montesquieu, 2011).
The successful implementation of the models identified above has seen significant progress towards alleviating extreme poverty. However, those models certainly require high initial investment that may limit the other microfinance providers’ capability to take part in serving the poorest (El-Zoghbi et al., 2009). This thesis will also contribute to the literature by suggesting an alternative model of ICBM that may have the potential to effectively serve the poorest.

1.5. Thesis outline

This thesis contains nine chapters: Chapter One introduced the thesis; Chapter Two will present the reviews of the literature; Chapter Three will develop the theoretical framework of ICBM, institutional sustainability and outreach; Chapter Four will present the methodological approach; Chapter Five will present the background and context of the Islamic microfinance industry and the ICBM profile in Indonesia; drawing on the case study findings, Chapter Six will examine the sustainability of the case study ICBMs; Chapter Seven will examine the outreach of ICBM; Chapter Eight will develop a new ICBM model for application in Indonesia; and Chapter Nine concludes the thesis and proposes future research directions.

Chapter One: Introduction

This chapter introduced the thesis by setting out both the background of the research and the research questions. The chapter discussed the competing debates around the achievement of the dual objectives of microfinance: sustainability and outreach. It presented a case for how the use of Islamic charity can enhance the achievement of those objectives. Finally, it discussed the methodological approach to respond to the research questions and suggested how the research findings may contribute to related literatures.

Chapter Two: Islamic Microfinance: theory and development

This chapter will present the literature reviewed related to the concept of microfinance and Islamic finance. The review will trace the development of microfinance theory, beginning with microcredit, and the microfinance revolution to current issues in
microfinance particularly those around the inclusion of the poorest in microfinance. The major concepts salient to Islamic finance will be discussed in the context of how these concepts can be practically implemented in microfinance. The chapter will discuss the major problems of microfinance and how Islamic finance can provide benefits to address the existing microfinance challenges.

Chapter Three: The framework on sustainability and outreach of the Islamic charity based microfinance

Chapter Three will develop the framework for this study. Initially, this chapter will present the concept of ICBM and the importance of tackling poverty in Islam and the role of Islamic charity in poverty alleviation. Then, the characteristics of three types of Islamic charity including zakat, waqf and shadaqa will be closely examined. It will highlight the debates on the nature of Islamic charity and its suitability to microfinance practice. This chapter will show that ICBM has more similar characteristics to non-profit organizations than to those of microfinance institutions. Therefore, a non-profit approach to institutional sustainability and outreach will be employed in this study. This chapter will provide definitions on institutional sustainability and outreach, and will examine the factors influencing the achievement of both institutional sustainability and outreach.

Chapter Four: Research methodology

This chapter will discuss the study’s methodology and data analysis. Initially, this chapter will explain the reason of using case study as the overall methodological framework. Then, it will present sampling procedures and an explication of the primary and secondary data collection methods: questionnaires, in-depth interview and direct observation. This data will be analyzed using qualitative and quantitative approaches. Institutional sustainability will be analyzed using a general inductive approach, while the outreach-related data will be analyzed using a descriptive approach, a national poverty line analysis and a binomial logit regression model.
Chapter Five: Islamic microfinance and Islamic charity based microfinance in Indonesia

This chapter will present a contextual background explication of the Islamic microfinance sector in Indonesia. This chapter is written using the information generated from the fieldwork and the exiting literature. First, this chapter will explore the history and the development of Islamic microfinance in Indonesia. Then, the key providers of Islamic microfinance, regulations and their characteristics will be explored. The discussion will show that market segmentation is evident in the Indonesian Islamic finance sector, whereby each type of provider selects different target clients. Then, this chapter will highlight the increasing participation of Islamic charity institutions within Islamic microfinance practice. Descriptions of two major providers of ICBM: zakat organizations and Baitul maal and the selected institutions as case study examples are presented.

Chapter Six: Examining the sustainability of ICBM

This chapter will present the findings on the institutional sustainability of the ICBM case examples. Using qualitative data from interviews, it will spotlight the distinctive uniqueness of the institutions’ programs and the factors affecting their institutional sustainability. This chapter will identify several factors that positively enhance the sustainability of the institutions including the ability to generate funding, and the selection of innovative strategies related to institutional fundraising, product development and public accountability. Additionally, this chapter will also describe several factors that may jeopardize the institutional sustainability of ICBMs. By developing linkages between the influencing factors, this chapter will draw together the findings of this study.

Chapter Seven: Examining the outreach of ICBMs

This chapter will present the research findings on the outreach of ICBM. It will discuss whether the case study ICBM institutions target the poorest of the poor in their microfinance programs. Initially, this chapter will discuss the coverage and the targeting of these programs. Then, using the survey questionnaire data, this chapter will examine the profile of the case study ICMB institutions’ clients and non-clients using a
descriptive analysis, a poverty line analysis and a binomial logit model. The overall finding will indicate that the clients of ICBM are not the poorest of the poor, but the vulnerable poor who have similar characteristics to those who have not participated in an ICBM program. This chapter then will identify several barriers that stand in the way of ICBM institutions being able to serve the poorest in Indonesia.

Chapter Eight: The future of Islamic charity based microfinance in Indonesia

Chapter Eight will ascertain the necessary elements to develop a successful ICBM model derived from the findings reported in the two previous chapters. This thesis suggests that ICBM should not provide financial services directly to the poor. Instead, ICBM should play a role as a preparatory institution that increase the capability of the poor to participate in microfinance initiative. This chapter will argue that ICBM should be developed and included in the formal microfinance sector in Indonesia on the grounds that the successful implementation of the proposed model has a significant role to play in promoting inclusionary microfinance practices.

Chapter Nine: Conclusion

As the concluding chapter, Chapter Nine will revisit the research objectives and report on the achievement of those objectives. Chapter-by-chapter findings will be illuminated to develop the whole arguments of this thesis. Future research directions will conclude the chapter.

1.6. Definitions of key terms

Several key terms will be frequently used throughout this thesis. To provide precision, those key terms will be defined in this section.

a. Islamic charity

Islamic charity refers to zakat as compulsory charity and shadaqa and waqf as voluntary charity (Ashraf and Hassan, 2012). The characteristics and the roles of each type of charity will be further discussed in the Chapter Three.
b. Microfinance

Microfinance is defined as provisions of small scale financial services for the poor clients. This thesis believes that microfinance clients represent not only micro entrepreneurs seeking productive loans, but are also representative of whole segments of the poor who need financial services to various purposes (Christen et al., 2003). The various definitions and debates in microfinance will be presented in the Chapter Two.

c. Islamic microfinance

Islamic microfinance refers to the application of Islamic finance principles to microfinance practices (Ahmed 2002). Islamic microfinance institutions needs to adopt Islamic finance principles to design their microfinance products and services (Obaidullah 2008). Further discussions on Islamic finance principles and how the principles are applicable to microfinance will be presented in the Chapter Two.

d. Islamic Charity Based Microfinance (ICBM)

ICBM refers to a program/an institution that utilizes Islamic charity as the major sources of funding to provide microfinance services to the poor. The discussion roles of Islamic charity in microfinance will be presented in the Chapter Three.

e. Institutional sustainability

Institutional sustainability refers to as the ability of an institution to survive and to continuously serve its constituency (Weerawardena et al., 2010). In this study, it is measured by the ability of the institutions to generate income, to implement innovative strategies, to obtain community support, to provide accountability, to reduce operational cost, to achieve high repayment rate and to comply with sharia. The discussion of this concept will be presented in the Chapter Three.

f. Outreach

Outreach refers to the ability of the institutions to effectively and efficiently deliver microfinance services to a diverse range of poor clients. In this study, it is measured by the number of clients, the product range, and the poverty level of the clients served by the institutions.
g. ICBM clients and non-clients

ICBM clients refer to the ones who had been participating in the institution’s program for less than three months. The non-clients refer to the ones who closely matched the ICBM clients demographically and in income levels, but differed with respect to their non-involvement in an ICBM program.

h. Poor and poorest

This study uses expenditure approach to measure poverty level of the clients. The poor refers to the population who live under the national poverty line. The poorest of the poor refers to bottom half of population classified as the poor.

1.7. Conclusion

This chapter introduced the thesis by arguing the case for the significance of the participation of the Islamic charity sector in microfinance initiatives in Indonesia. Then, it developed the research questions by presenting the competing objectives of microfinance and the benefits of utilizing Islamic charity in microfinance. This thesis examines the institutional sustainability and the ability of microfinance to include the poorest by conducting a case study in Indonesia. The overall framework of the research conducted is a case study methodology. This study is intended to contribute to the literature on microfinance and Islamic finance. It will propose an alternative model of microfinance that works for the poorest and that also provides empirical evidence for the use of Islamic charity in microfinance. Lastly, the chapter presented an outline of the thesis and provided the definitions of key terms of this thesis. The development and theory of Islamic microfinance will be discussed in the following chapter.
Chapter 2

Islamic microfinance: theory and development

2.1. Introduction

This chapter presents the literature review on Islamic microfinance. It provides theoretical discussion of microfinance and a discussion on how the concept of Islamic finance can be applied to microfinance. The overall concepts underpinning microfinance are aligned with the Islamic finance concept (Obaidullah and Khan, 2008, Dhumale and Sapcanin, 1998). Microfinance and Islamic finance endeavors can be likened to a mission to address social inequalities and promote entrepreneurship.

The chapter is framed around three main sections. Section 2.2 will present the theory of microfinance, its objectives and success factors, two major microfinance paradigms and the achievements of and challenges facing microfinance. Section 2.3 will examine the theory of Islamic microfinance, focusing on its basic concepts, its similarities and differences with microfinance, its schemes of transaction and the worldwide application of an Islamic finance scheme. Section 2.4 provides a concluding discussion.

2.2. The theory of microfinance

Microfinance is not a new concept. As documented in many parts of the world, a similar intervention to microfinance practices date from the 1800s. The pioneer of an early formal financial institution that served the poor was widely evident in Europe in the 1800s (Helms, 2006, Seibel, 2003). For example, in the 1840s in Ireland, the Irish Loan System was a sustainable system that provided about 300 types of microfinance funds. In Germany, the notion and practice of microfinance continued to be developed at a time when more formal institutions were established under a financial cooperative system. The success of microfinance in this period promoted the development of regulated microfinance institutions that mobilized savings and distributed loans through credit cooperatives. As another type of early microfinance provider, village banks were
established in Indonesia during the Dutch Colonial period in the 1890s (Rosengard et al., 2007). The village banks became one of the major providers within the microfinance system in Indonesia with close to 9,000 institutions providing credit for mostly agricultural initiatives. The success of Indonesian village banks led to their adaptation for wider use in parts of rural Latin America in the 1900s.

The use of microcredit increased in popularity following the development of the Grameen Bank in Jobra Bangladesh by Muhammad Yunus in the 1960s. Yunus witnessed that people in Jobra needed financial assistance in the form of credit to secure their food supply and to provide working capital for their small businesses. However, due to the potential risks associated with serving the poor, none of formal financial institutions were willing to provide credit for this financially destitute group. This situation meant that in order to receive financial support, the poorest of the poor had few options other than turn to informal money lenders who charged unreasonably high interest (Yunus, 1999). Yunus (1999) argued that structural problems in society’s economic systems present significant barriers in relation to assisting the poor to expand their economic capacity. This issue thus motivated him to develop more affordable and accessible microcredit options for the poor.

Evidence from the literature suggests that microcredit arrangements offer a viable alternative financial system to serve society’s poor. That this group may have little or no physical collateral to secure a loan may contribute to the reluctance of existing financial institutions to provide finance in fair and equitable ways (Armendáriz and Morduch, 2005). First introduced by the Grameen Bank, a group lending mechanism offers a solution to the issue of inadequate collateral. Group lending refers to a system in which individuals form groups to secure loans from a lender (Bakshi, 2010). In this system, loans are typically disbursed to the individual borrowers, but all borrowers within the group agree to guarantee other members’ repayments if any member defaults. As such, this loan and repayment strategy is made more effective through peer pressure. Further, lending to a group under this group guarantee mechanism has the potential to reduce non-performing loans as well as reducing transaction costs in credit delivery by transferring the roles of information acquisition, loan monitoring and loan enforcement from the bank to a group of borrowers (Dusuki, 2008b). As another distinctive
characteristic, microcredit institutions generally prefer to select women as clients due to several reasons. Women were known to be more willing to work harder to get out of poverty since they would use their money for family purposes such as providing better living conditions for their children. Women were also understood to be more reliable than men in meeting loan repayments (Yunus, 1999, Helms, 2006, Khandker et al., 1995).

The original microcredit program was fundamentally not only a loan program but also a savings and peer business mentoring program (Dowla and Alamgir, 2003). Attendance at weekly meetings and mandatory saving were preconditions before participating in microcredit. The term microcredit had been replaced by the term ‘microfinance’ over the period 1980-1990s. During this period, the worldwide application of microfinance came to be seen as an important strategy in the alleviation of poverty. The emergence of a new microfinance paradigm prompted arguments around the idea that if microfinance institutions are willing to serve more people, then they must remain financially sustainable (Robinson, 2001). This period came to be known as the microfinance revolution. Compared to the original notion of microcredit, microfinance offers more diverse financial products, ranging from micro-savings deposits, microloans, micro-insurances, and other fee based financial services.

The literature evidences multiple definitions of microfinance. Many contributors to the field agree that microfinance provides small scale financial products, but they have different opinions on who constitutes the microfinance target market. Robinson (2001) defines microfinance as:

Small-scale financial services—primarily credit and savings—provided to people who farm or fish or herd, who operate small enterprises or microenterprises where goods are produced, recycled, repaired, or sold, who provide services, who work for wages or commissions, who gain income from renting out small amounts of land, vehicles, draft animals, or machinery and tools, and to other individuals and groups at the local levels of developing countries, both rural and urban (Robinson, 2001 p.9)

Similarly, Karlan and Goldberg (2011) describe microfinance as the provision of small scale financial services to people who lack access to traditional banking services. It
implies a small loan to low-income clients for self-employment, often with simultaneous
collection of a small amount of savings (Karlan and Goldberg, 2011 p. 20).

The definitions articulate that although microfinance provides both credit and savings
for the poor, it is primarily designed for the poor who have some employment skills. In
contrast, Christen et al. (2003) argue that microfinance clients represent not only micro
entrepreneurs seeking productive loans, but are also representative of whole segments of
the poor who need financial services to finance emergency needs, acquire assets, acquire
and renovate homes, smooth consumption expenses and meet social obligations
(Christen et al., 2003).

Debates around who should be the clients of microfinance occur due to the prevalence
of different approaches designed to achieve best microfinance practices. Microfinance
theories and practices are generally characterized by two different paradigms:
institutionalist and welfarist (Woller et al., 1999). These paradigms have critical
implications for how institutions determine their mission, vision and goals, target clients
and develop loans distribution strategies.

Early microfinance practices were shaped by the welfarist argument and worked mostly
on the basis of charitable motives (Schicks, 2007). The Grameen Bank in Bangladesh
and FINCA village bank in Canada, as pioneers of contemporary microfinance practices,
are case exemplars of the welfarist microfinance paradigm. These institutions depend on
external donor funds to accomplish their mission in providing subsidized financial
services for the poor. For welfarist microfinance institutions, an institution is not always
necessary to generate sufficient revenue to cover all the operational and financial costs.
However, a microfinance institution (MFI) can be viable in the long run even though it
is dependent on donor funds (Woller, 2002)

The welfarist microfinance institution argues that to advance its social mission,
microfinance needs ongoing donor support to cover the costs of non-economic related
services, such as training, business development and social intermediation (Shaw and
Clarke, 2006). These services are integral to microfinance institutions that are focused
more on improving the social and economic wellbeing of their high risk and high cost
poor clients than on deriving commercially driven profits from higher financially diverse groups.

The institutionalist paradigm emerged during the 1990s when existing microfinance institutions were not performing well, due to low rates of loan repayments, high losses, high client dropout rate and widespread corruption (Robinson, 2001). The institutionalist microfinance perspective equates the success of microfinance programs with their ability to achieve financial sustainability. By establishing high levels of financial sustainability, institutions can provide high quality financial services to larger numbers of poor clients. The objective of financial sustainability can be achieved by transforming the institutions into profit seeking institutions that do not depend on donor support in the long run (Ledgerwood and White, 2004). The institutionalist’s argument is influenced by the main theory of capitalism in which prosperity depends upon the progressive creation of private wealth (Khan, 2011). Success or otherwise in the achievement of financial sustainability, lies in the careful design and implementation of the institution’s microfinance programs. Bank Rakyat Indonesia (BRI) and BancoSol in Bolivia are excellent examples of institutionalist microfinance providers.

Although the welfarist and institutionalist microfinance paradigms have in common the aim to alleviate poverty, they each take a different direction towards best achieving this aim. A key strength of the welfarist position is its inclusion of all segments of the poor and its focus on a social mission. By contrast, from an institutionalist perspective, the achievement of financial sustainability represents a key strength. The summary of welfarist and institutionalist paradigm is presented in Table 2.1.
Table 2.1: The contrast between the institutionalist and the welfarist paradigms

<table>
<thead>
<tr>
<th></th>
<th>Institutionalist</th>
<th>Welfarist</th>
</tr>
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<tbody>
<tr>
<td>Other terms</td>
<td>Mainstream microfinance,</td>
<td>Poverty focused microfinance</td>
</tr>
<tr>
<td>Alternative descriptive terms</td>
<td>Financial system development</td>
<td>Subsidized credit</td>
</tr>
<tr>
<td></td>
<td>Commercial microfinance</td>
<td></td>
</tr>
<tr>
<td>Key objective</td>
<td>Financial sustainability</td>
<td>The depth of the outreach</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(providing financial access for very poor clients)</td>
</tr>
<tr>
<td>The need for donor funds</td>
<td>Only necessary for initial development</td>
<td>Requires on-going donor support</td>
</tr>
<tr>
<td>Clients</td>
<td>Non poor and not so poor clients</td>
<td>All levels of the poor</td>
</tr>
<tr>
<td>Services</td>
<td>Financial products only</td>
<td>Microfinance and social</td>
</tr>
<tr>
<td></td>
<td></td>
<td>development programs</td>
</tr>
</tbody>
</table>

Source: author’s compilation from various sources (Woller et al., 1999, Robinson, 2001, Shaw and Clarke, 2006)

The literature review suggests there is wide agreement on the idea that microfinance was originally designed to serve the poor. However, decisions salient to the question of who of society’s poor should be targeted for inclusion in microfinance programs have been less than straightforward in their resolution as evident in both institutionalist and welfarist debates (Wright, 2000, Hulme and Mosley, 1996).

Sen and Nussbaum (1993) argue that poverty can be seen as a lack of both an individual’s personal capabilities and social and economic freedoms. This viewpoint implies that people living in poverty may have a different range of capabilities that may or may not facilitate the poor’ participation in microfinance. Microfinance is ideally a mechanism designed to enhance client’s everyday living and employment capabilities. However, it may only be suitable for those with appropriate levels of skills required for running a particular microenterprise (Hulme and Mosley, 1996).

In her explication of the capability concept, Robinson (2001) categorizes the poor as either the economically active poor or the extremely poor. Those who find themselves
living in extreme poverty are likely to be unemployed or severely underemployed, or have an income too low to afford the minimum food energy intake required to avoid malnutrition (Robinson, 2001). People who may lack the capability to engage in productive activities such as the elderly, the disabled and the infirm are also included in this extremely poor group. Although the extremely poor may not qualify as suitable microfinance clients, they may benefit indirectly from the development of microfinance. On the other hand, the ‘economically active poor’ are likely to be fortunate enough to have some form of employment and as such, may not necessarily be suffering poor nutrition. Accordingly, Robinson (2001) argues that microfinance may only be suitable for the economically active poor.

Robinson’s (2001) argument is also supported by the proponents of the institutionalist view. For example, Wright (2000) asserts that microfinance programs should focus on the non-poor, or vulnerable poor, which includes those who are clustered above the poverty line; while the very poor may require a range of relief services before they can participate effectively in microfinance. Similarly, Zeller and Meyer (2002) believe that microfinance is not suitable for the poorest of the poor as most are faced with the constant battle to both fulfill their basic survival needs and deal with systematic constraints. Additionally, Hulme (2000) maintains that such constraints present difficulties for many of the poor in repaying their loans on time.

The current microfinance discussion has moved to more broadly consider the inclusion of the very poor in microfinance programs. There are significant efforts being made by scholars and practitioners to find the best model of microfinance that can include the poorest without jeopardizing institutional sustainability (Simanowitz and Walter, 2002b). Morduch and Haley (2002) argue that a broad range of clients, including the poorest of the poor, can benefit from their participation in microfinance. Clear targeting strategies and appropriate product design are necessary for microfinance to successfully work for the poorest (Wright, 2000).

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1 The term poorest of the poor, the very poor and the extremely poor in this thesis are used interchangeably
A study by the CGAP found that the poorest could not easily participate in microfinance directly, unless they have first engaged in sequential interventions to enable them to move out of poverty. Such interventions may include the provision of food transfer and skills training, and financial support through savings accumulation plans and asset grants. Using the dataset of the BRAC microfinance program in Bangladesh, Mallick (2012) justifies the importance of providing support packages, including asset grants, enterprise management assistance and living allowances to increase social capital and awareness of the extreme poor prior to their joining microfinance programs.

Adopting this view, the CGAP developed a microfinance model for the poor named The Poverty Graduation Model. This model provides a pathway of sequential interventions to facilitate the poorest’s graduation from poverty. The pathway combines a safety net and long term planning for investments in human capital to protect the participants’ welfare in the short term and to prepare the poorest for their participation in microfinance (El-Zoghbi et al., 2009). However, the issue of the availability of readily accessible and reliable sources of sufficient funding to provide sequential services to the poor needs to be addressed before the model can be scaled up.

The debate about who should be the target clients of microfinance has not been resolved, and may not need to be. As Rhyne (1998) notes, all those involved in the provision of microfinance share similar objectives related to providing credit and saving services for poor people in a long term sustainable way. It is not a debate, but it is about the issues of market segmentation of various microfinance providers. This thesis argues that both institutionalist and welfarist approaches can be present to serve clients experiencing different levels of poverty, as the poor have diverse capabilities in utilizing financial services available due to different income, assets, skills, and levels of education. Different microfinance providers can cater for diverse clients with correspondingly diverse needs. The argument set out in this thesis accords with those of Christen et al. (2003), Simamowitz and Walter (2002), and Morduch and Haley (2002) who support the notion that microfinance should unconditionally provide financial services for all segments of the poor by carefully designing its products and services to meet the needs of the poor.
2.2.1. Microfinance objectives and its success factors

Microfinance institutions have the dual objective to achieve financial sustainability and a wide client outreach (Ledgerwood, 1998). They focus not only on generating profit to achieve financial sustainability, but also on providing financial services for the poor, with an intention to encourage this group to engage in income earning activities and to accumulate wealth.

This conceptualization of the defining characteristics of microfinance may raise problems in the future to balance the dual objective noted above. In addition, Zeller and Meyer (2002) suggest that the third indicator of microfinance performance is impact. They argue that the expected impact of microfinance programs should be made transparent to donors in order to inform their investment decisions. Therefore it is necessary to provide an indicator that reflects the potential social benefits of the program. The three performance indicators, sustainability, outreach and impact, are well-known as constituting the triangle of microfinance (Zeller and Meyer, 2002). These microfinance performance indicators are further described in the following.

2.2.1.1. Sustainability

The first performance indicator of microfinance is sustainability. Definitions of sustainability vary depending on their alignment with the different microfinance paradigms discussed above. The institutionalist defines sustainability as the ability of an institution to cover all of its costs including operational and financial costs (Ledgerwood, 1998). MFI’s sustainability is dependent on the extent to which the institution is subsidized by others (Ayayi and Sene, 2010). A determination of a microfinance institution’s sustainability can be considered at three levels: donor dependent, operational self-sufficiency and financial self-sufficiency (Ledgerwood, 1998, Torre and Vento, 2006). At the lowest level of sustainability, the donor-dependent institution relies totally on donor funds to cover all costs incurred in the business. This type of institution provides microcredits to the very poor clients at interest rates lower than the market rates. The financial sustainability of donor-dependent institutions thus depends mainly on donor subsidies. At the operational self-sufficiency level of
sustainability, the institution can generate income to cover all of its operating costs. However, this income may not be sufficient to cover all other financial costs. The highest level of sustainability, financial self-sufficiency, is achieved when the institution can meet all operational and financial costs.

According to welfarist arguments, it is not always necessary to achieve financial self-sufficiency as an institution can be viable in the long run even though it may be entirely dependent on donor funds (Woller et al., 1999). The welfarists argue that the institutionalist approach neglected to recognize the non-financial interests of socially ethical investors who seek less tangible returns such as the social indicators related to nutritional standards, income levels of the poor, water accessibility and quality, and access to education rather than on financial returns. These social-interest investors provide substantive funding for thousands of successful nonprofit organizations. These organizations have survived over the long run despite their dependence on subsidies. Their sustainability is driven by their capability to constantly deliver social benefits for the society (Morduch, 2000, Zeller and Meyer, 2002).

2.2.1.2. Outreach

In addition to sustainability measures and financial indicators, the performance of microfinance can also be determined by its ability to effectively and efficiently deliver high quality services to a diverse range of poor clients. This measure is known as outreach. From a donors’ perspective, a measure of outreach is crucial in order to make sound investment decisions regarding the allocation of their funds to programs that are most likely to have a significant impact on poverty reduction. Additionally, from the perspective of the microfinance institution, a measure of outreach provides information in relation to the characteristics of the clients and the distinctive challenges and issues they face. This information is important to enable institutions to custom design products and services that meet their clients’ specific needs.

Outreach can be measured in two dimensions: breadth and depth. The breadth is simply a scale of the microfinance institution’s activities (Ledgerwood, 1998). More specifically, this dimension refers to the number of clients the institution serves, its product range
and the coverage of its programs. Breadth becomes an important issue as the institution generally has a limited budget available for loan disbursement. This limited budget may constraint the capacity of the institution to provide microfinance services to all poor. Although the breadth of outreach may be straightforward to measure, any measurement cannot provide a complete picture of the capacity of a particular microfinance institution to reach the particular level of the poor. Alternatively, the depth dimension of outreach provides a more in-depth picture of the types of clients reached and their poverty level (Polanco, 2005, Christen, 2000, Cull et al., 2007). The depth of the outreach is commonly proxy by the average loan size per client and/or the average loan size as a percentage of GDP per capita (Ledgerwood, 1998). However, this proxy may provide biased information as loans may be used for different purposes (Meyer et al., 2000). Alternatively, information about income and wealth, gender, location, access to public facilities, education, housing and ethnicity may be used as a proxy for clients’ levels of poverty (Schreiner, 2002). However, the interplay of contextual factors such as culture and the original mission of the MFIs, complicate measurement of the depth dimension of outreach.

Achieving adequate outreach depth can be challenging for microfinance institutions. The common key depth-related question here is ‘Can microfinance reach the poorest of the poor in the program?’ This is a complex question to respond to as on the one hand, success in reaching the poorest realizes one of the objectives of microfinance in addressing poverty alleviation, but on the other hand, reaching the poorest may incur high costs that risk institutional sustainability. Further challenges to serving the poorest may arise from a lack of capability of the poorest to participate in microfinance. As such, the MFIs need to address ways to build poorest’ capability and in so doing, enhance their participation prospects.

As the institution becomes more commercially oriented, the issues related to mission drift can arise. In such instances the microfinance institution may attempt to select a specific market share in order to reduce its operational costs by targeting more accessible and less risky consumers. Rhyne (2005) defines mission drift as the shift from offering small loans to the poor to offering larger loans to significantly less financially needy clients. Zeller and Meyer (2002) argue that this tradeoff may result in a large
proportion of fixed costs component in total transaction cost; so unit costs for smaller loans or smaller deposits are higher compared to those for larger financial transactions. Furthermore, Ledgerwood and White (2004) note that mission drift might be necessary in order to recover the high costs of transforming the institution into a profit seeking institution. The institutions tend to seek higher income clients that might allow them to generate greater profits.

Previous studies have discussed the tradeoffs between targeting and serving the poor, achieving adequate outreach depth and breadth and achieving financial sustainability. Much research has arrived at differing conclusions in relation to the issue of mission drift in microfinance. Cull et al. (2007) found that the institutional design and mission of MFIs are important in describing the tradeoff between outreach and sustainability. They note that tradeoffs frequently emerge within group lending rather than in individual lending contexts. This argument is in line with Christen (2000) who states that mission drift, which is usually indicated by larger loan size, is caused by the interplay of several factors such as strategy decisions, the age of the institution and the characteristics of the target client group. Christen (2000) argues that the reasons for differences in the average loan size between regulated and unregulated institutions in Latin America may be due to differences in the institutions’ initial choice of target clients. The primary mission of regulated MFIs was to develop small enterprises with the intention that the economic active poor manage these. In contrast, unregulated MFIs usually focus on the poorest of the poor especially very poor women who borrow small amounts of loans. Differently, Polanco (2005) confirms that MFIs may allow tradeoffs between profitability and depth of outreach in Latin America. He found that the more competitive the microfinance industry, the larger the average loan amount balance per client. This finding implies that MFIs search for more profitable clients in a more competitive industry.

2.2.1.3. Impact

Offering a more comprehensive way to measure microfinance institutional performance, Zeller and Meyer’s (2002) microfinance ‘triangle’ takes into account a third perspective of performance, namely the welfare impact of microfinance on society. Impact measurement requires making comparisons between the social costs and social
objectives of microfinance. As an MFI’s operations are not fully independent of its donor funds, a performance measurement that could provide donors with multi-faceted information about the social benefits derived from their investments is crucial. The fundamental question on impact is: how has participants’ quality of life changed after joining the programs? An evaluation of the impact of microfinance on the individual client or client group, their families, and on their immediate communities is important to inform and improve upon future projects as well as to encourage donors to invest in programs that are likely to have highly positive impacts (Karlan and Goldberg, 2011).

From the literature review, there appears to be sufficient evidence to suggest that microfinance programs have a positive impact on reducing the financial burden on those living in poverty (Morduch and Haley, 2002, Brau, 2004). Specifically, although there is further evidence suggestive of positive effects on smoothing income and increasing income, there is less evidence pointing to significant advances in health and nutritional status and education (Morduch and Haley, 2002). In relation to the capacity of an MFI to provide financial services for the poorest, Goldberg (2005) states that the Grameen Bank’s small and flexible loan program works more effectively for the poorest than the less poor in terms of rates of loan repayment and increases in clients’ microenterprise sourced incomes. Similarly, Simanowitz and Walter (2002b) present case studies of the microfinance institutions CRECER and SHARE that have achieved significant positive impacts on the lives of the poorest in several indicators including fulfillment of basic needs, reductions in financial vulnerability during crisis periods and the empowerment of women.

Furthermore, the positive impacts of microfinance programs can be further increased if they are delivered alongside and integrated into other development interventions. The study by Leatherman and Dunford (2010) describes the positive impacts of the provision of integrated microfinance on clients’ health status and the consequent impact on clients’ and their families’ financial security and productivity. Another study by Matin et al. (2008) looks closely at the BRAC project, namely the Targeting the Ultra Poor (TUP) program in Bangladesh. These researchers found that by integrating microfinance with other mainstream development activities such as food transfer, established savings
initiatives, and training, the institution was able to expand on the anticipated benefits of a conventional standalone microfinance program.

Microfinance also works effectively if it targets women clients. Using data from Indonesia, Panjaitan-Drioadisuryo and Cloud (1999), research into the microfinance program of Bank Rakyat Indonesia (BRI) in Lombok Island found that during and following the implementation of a microfinance program, women clients were able to increase their income substantially, improve their nutritional status, and repay their loans on time. The study also found that women who participated in the program held higher educational aspirations for their children and were more concerned about family planning.

Microfinance has attained significant achievements in its wide outreach and its largely positive impacts on the availability and accessibility of welfare services and other development indicators over the last decade. Data collected from 3,859 microfinance institutions worldwide reported in the Microcredit Summit Report 2011, show that by the end of 2009, 190.1 million clients had participated in microfinance (Reed, 2011). However, microfinance has served around only ten percent of the total number of people living in poverty worldwide (Armendariz and Labie, 2011). In their study, Armendariz and Labie (2011) identified that microfinance’s limited achievements are due to a major problem related to a mismatch between microfinance products offered and client needs. Many of society’s poor are excluded from participating in microfinance activities due to the inability of microfinance to address the poor’s needs. Dunn (2002) and Woller (2002) argue that a better understanding of clients’ needs may translate into improved products and services, and more successful program implementation and evaluation processes. Such improvements may enhance financial sustainability and the reputational standing of microfinance institutions.

A mismatch between financial services offered and the institutions’ knowledge and awareness of clients’ financial needs is widely evident in Muslim countries. The study by Karim et al. (2008) found that 72% of people living in Muslim countries do not use formal financial services due to their reluctance to participate in interest based loan transactions. The adoption of an Islamic finance approach to microfinance can provide
an alternative way to meet the needs of Muslim poor who require Islamic compliant microfinance. Therefore, in Muslim dominated countries, synergies between Islamic finance and microfinance may possibly increase financial inclusion of the poor.

2.2. Islamic microfinance

Similar to other microfinance practices, the application of Islamic finance into microfinance is guided by three aspects including the eradication of poverty, the promotion of socio-economic justice, and the equitable distribution of income in society (Chapra, 1995). These objectives should be unconditionally incorporated into an Islamic economic system. Under such guidance, Islamic banking institutions should not only be able to maximize their profits, but also promote social justice by ensuring an equitable distribution of wealth in society.

2.2.1. The concepts of Islamic microfinance

Islamic microfinance practices reflect the integration between two concepts: Islamic finance and microfinance. Islamic Microfinance can be defined as the application of Islamic finance principles to provide micro scale financial services to the poor (Obaidullah, 2008). Islamic finance is the concept of finance grounded on the Islamic principle – sharia. The core belief of Islamic finance holds that money is not intended to be an earning asset and as such, cannot be traded as a commodity. This belief implies that all financial transactions must be representative of real transactions, or of the sale of goods, services or benefits (Ayub, 2007). There are three basic concepts of Islamic finance: the prohibition of riba (usury), the prohibition of gharar (uncertainty and speculation), and the prohibition of unethical investments involving alcohol, prostitution and/or gambling.

The foundations of Islamic finance are based on the Qur’an. The prohibition in the Qur’an against riba is clearly stated in several verses: 30: 39, 4: 160-161, 3: 130, 4: 29, 2: 188, and 2: 275-280. Each of these verses states that any revenue derived from a lending contract, regardless its size and its rate is considered as riba. Riba is a form of exploitation, specifically in the case of microfinance, where higher interest rates are
charged to low paid earners (Wilson, undated). Dhumale and Shapcanin (1998) define riba as the additional amount that debtors have to pay above the principal. Riba can be derived from any return from the exchange of money for money and/or any delay on payment on agreed prices.

The prohibition on the payment of interest on loans is the mechanism by which Islam promotes justice in financial transactions. Riba is prohibited because it exploits borrowers by making the lender better off at the expense of borrowers (Abdul Rahman, 2007). The use of a predetermined interest rate can be unfair for the borrower if, in the face of a struggling business, they have to continue to pay a fixed interest rate. Conversely, it becomes inequitable for the lenders, if they only receive a small percentage in the rate of return when the borrower may be making considerable profits (Khan, 2008). Interest rates are considered a form of exploitation and an injustice which is inconsistent with the Islamic principles of fairness and property rights (Kettell, 2010).

Gharar is another main principle of Islamic finance that is prohibited by Sharia. Gharar refers to entering into a contract that involves high levels of risk or uncertainty about the ultimate financial outcomes of the contract (Ayub, 2007). Gharar occurs because of a lack of relevant information that can lead to uncertainty and exploitation of any other parties to any transaction. For example, Islamic finance prohibits gambling, selling in-utero lambs, and any derivative products such as futures and options because of the uncertainty involved in the future delivery of the underlying assets.

Islamic banks attempt to remove all forms of fixed nominal interest rates and avoid any speculative transactions. Hence, the profit loss sharing mechanism (PLS) comes into play to replace interest based transactions on resource allocation and financial intermediation. In a PLS scheme, Islamic banks do not charge any interest but rather, participate in yield resulting activities. The PLS encourages partnerships between banks and depositors, as well as between banks and borrowers.

2.2.2. Islamic microfinance: a literature review

The review of the Islamic microfinance literature suggests that the subject of Islamic microfinance is a relatively new phenomenon. Research into Islamic microfinance
subject was first reported in the late 1990s with the work of Akhtar (1997) and Dhumale and Sapcanin (1998) among the earliest cited literature in Islamic microfinance discourse. After the turn of the century, several important works in Islamic microfinance were published (see Obaidullah, 2008, Obaidullah and Khan, 2008, Ahmed, 2002, Hassan, 2010, Karim et al., 2008, Seibel, 2008). These works have been endorsed by some of the major donor institutions and research bodies including the World Bank, the Islamic Development Bank, the UNDP, the CGAP, and the GTZ. Much of the Islamic microfinance research literature is theoretical in nature. Although the empirical research literature focused on Islamic microfinance is sparse, notable exemplars include studies by Seibel (2008), reporting on the performance of three types of microfinance institutions in Indonesia, and research by Karim et al. (2008) and El Zoghbi (2012) on the performance and outreach of Islamic microfinance worldwide.

In 2012, a CGAP study by El Zoghbi reported that currently there are 256 Islamic microfinance institutions across 19 countries, serving a total of 1.28 million clients and with USD 713 million in outstanding loans. On the location of these institutions, 46% are located in Middle East and North Africa (MENA), 37% in South Asia (SA), 14% in East Asian and Pacific (EAP), 2% in Europe and Central Asia (ECA) and less than 1% in Sub Saharan Africa (SSA). The outreach and total financing of these Islamic microfinance institutions remaining concentrated in a few countries: Bangladesh, Indonesia and Sudan. Compared to 2007 CGAP data on Islamic microfinance, this sector has made good progress in reaching their clients and widening their service coverage, but has limited outreach compared to the non-Islamic microfinance sector (El Zoghbi, 2012). Islamic microfinance institutions represent less than 1% of both the total financing and total client base of conventional microfinance institutions.

The literature suggests some variability between the performance of Islamic banks and conventional banks. Seibel (2008) compared the performance of Islamic rural banks to that of conventional rural banks in Indonesia, and found that in general, Islamic microfinance institutions are less profitable than conventional types. Other studies also find that Islamic rural banks are less efficient. Indicating by higher operational cost than conventional rural banks (Karim et al., 2008). By contrast, Khan’s (2010) comparison of Al Akhuwat, a nonprofit Islamic NGO, and the Sarhard Rural Support Program (SRSP)
as a conventional microfinance in Pakistan, pointed out, Al Akhuwat was more efficient and profitable than its conventional SRSP counterparts.

### 2.2.2.1. The application of Islamic finance

The literature suggests that the concept of Islamic finance and microfinance are compatible with each other and that it is possible to integrate both concepts into Islamic microfinance. Both concepts are ideologically and practically linked (Dhumale and Sapcanin, 1998, Shahinpoor, 2009, Abdul Rahman, 2007, Askari et al., 2009). Ideologically, Islamic finance and microfinance support entrepreneurship and endeavor to promote and achieve social justice through the participation of the poor in microfinance development. Practically, many elements of microfinance are aligned with Islamic finance concepts (Abdul Rahman, 2007). Dhumale and Sapcanin (1998) note that the disbursement of collateral free loans is an example of how Islamic finance and microfinance share similar practices.

As discussed earlier in this chapter, microfinance practices exhibit several distinctive characteristics, including predominantly small scale transactions, the application of group lending mechanisms and a sharp focus on the inclusion of women clients. The application of group lending microfinance attempts to reduce asymmetric information in the credit market due to the absence of physical collateral (Dusuki, 2008a). Dusuki (2008a) notes that group lending mechanisms are not an alien practice of Islam as it is comparable in meaning to the concept of *as sabiyah as sabiyah* and group lending mechanisms share similar values such as teamwork, a sense of belonging, cooperation and trust. Dusuki (2008a) believes that utilizing religious principles as social capital would be beneficial for the successful application of the group lending mechanism. Dusuki’s (2008a) argument is supported by Ahmed (2002) who states that Islamic MFIs may take advantage of some religious values such as the Muslim obligation to repay the loan.

Pervasive throughout the Islamic microfinance literature is the observation that many Islamic microfinance practices are similar in their theoretical underpinning to
conventional microfinance concepts (Obaidullah and Khan, 2008). As an example, the application of conventional group lending mechanisms is evident in many Islamic microfinance institutions, such as in Yemen’s Hodeidah Microfinance Program in which 90% of the funding is disbursed through a group lending methodology (UNCDF, 2002). Other microfinance programs prefer to implement individual lending rather than group lending. Khan (2008) explores the Islamic Relief microfinance program in Bosnia, Pakistan and Sudan and argues that group lending cannot be implemented in regions where sociocultural ties are not necessarily high and where program participants are more individualistic than group-oriented in their approach to work. In Islamic Relief programs, loans are provided on an individual basis on the condition the individual has a personal guarantor, a compulsory savings plan in place and a recommendation from the community to ensure repayment of the loan. This method of providing loans on a conditional basis has been successful in its implementation, with repayment rates reaching 95%-99% (Khan, 2008). Similarly, the application of a group lending mechanism is rarely found in formal and regulated microfinance institutions in Indonesia. Rather, it is more popular for semiformal microfinance institutions, such as in an Islamic financial cooperative (Holloh, 2001).

Similar to debates within conventional microfinance discourse, issues around the question, ‘Should Islamic microfinance focus on providing financial services to women clients?’ are at the forefront in debates relating to the implementation of Islamic microfinance programs. As previously noted, one of the successful outcomes of the Grameen Bank’s focus on women clients was evident in increased rates of loan repayments suggesting woman may be more reliable than men in meeting their loan commitments. Ahmed (2002) argues that focusing on women as target clients might raise several challenges. For example, an asymmetric problem may occur when a male family member takes control of loan funds distributed through microfinance methods to a female family member (Rahman, 1999). Furthermore, this situation might create significant tension in the family, particularly in instances where the female member is put under pressure to apply for microfinance on the assumption that it is easier for a woman to obtain credit, and that if obtained, may be misappropriated by the male family member. In addition, Rahman and Khandker (1994) found that credit given to women is
more likely to generate a low rate of return from low risk and less productive ventures. Obaidullah (2008) and Ahmed (2002) suggest that Islamic microfinance should target all family members rather than just the women, as the provision of credit in a seemingly ‘women-only’ way, is a highly sensitive issue in Islam. The authors argue that by targeting the family as a unit, rather than just the women in the family, the financial risk will be shared by each family member. In fact, as for the situation in conventional microfinance, the 2007 CGAP survey reveals that on average, 59% of Islamic microfinance’s clients are women. This figure is significantly higher in several countries including Bangladesh (90%) and Saudi Arabia (86%). In contrast, in Mali and Afghanistan the average percentage of female borrowers is quite low (12% and 22% respectively) (Karim et al., 2008).

According to some researchers, many Islamic finance scholars share the view that Islamic microfinance should be integrated with Islamic charity institutions to provide improved and expanded services for whole segments of the poor (Hassan, 2010, Obaidullah, 2008, Ahmed, 2007). The incorporation of Islamic charities as a significant and additional source of microfinance funding will be beneficial to increase MFI’s sustainability since this type of funding is non-interest bearing. Islamic microfinance may use Islamic charitable funds in a complementary way to finance non-investment activities, such as assisting the poor to meet their basic needs, conducting training to enhance borrowers’ skills and capabilities, and contributing to other community development activities. These complementary activities may reduce the possibility of the clients in using their loan funds for non-productive purposes (Ahmed, 2002). As a result, the loan repayment default rate might be minimized. A summary of the similarities and differences between Islamic microfinance and conventional microfinance is presented in Table 2.2.
Table 2.2. A comparison between conventional and Islamic microfinance

<table>
<thead>
<tr>
<th></th>
<th>Conventional microfinance</th>
<th>Islamic microfinance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Source of funds</td>
<td>Donor funds, commercial funds and savings mobilization</td>
<td>Donor funds, commercial funds, savings mobilization and Islamic charity (zakat, shadaqah and wqaf)</td>
</tr>
<tr>
<td>Mode of financing</td>
<td>Interest based financing</td>
<td>Islamic finance instruments</td>
</tr>
<tr>
<td>Financing the poorest</td>
<td>Dependent on the institutions’ paradigms. The welfarist institution includes the poorest; while the institutionalist institution prefers the economically active poor.</td>
<td>The poorest can be served using Islamic charities</td>
</tr>
<tr>
<td>Target clients</td>
<td>Women</td>
<td>Families, with predominantly women constituting the major client base</td>
</tr>
<tr>
<td>Funds transferred</td>
<td>Cash given</td>
<td>Goods transferred</td>
</tr>
<tr>
<td>Approach to loan repayment</td>
<td>Group pressure and joint liability</td>
<td>Group pressure and joint liability and religious value</td>
</tr>
</tbody>
</table>

Source: author analysis derived from (Ahmed, 2002)

2.2.2.2. The application of Islamic financial instruments to microfinance

To avoid the imposition of fixed interest, Islamic finance offers various transaction schemes that can be implemented within the existing microfinance operating environment. These schemes can be applied depending on the characteristics and particular needs of the client. Islamic financial transaction schemes can be classified into four types of models: a participatory profit loss sharing model, a sales model, a leased model and a charitable contract. This classification was developed from the research findings of Dhumale and Sapcanin (1998), Dusuki (2008a) and Obaidullah (2008).
The participatory profit loss sharing model

The participatory profit loss sharing model is understood to be the most preferred lending scheme as it encourages the participation of both the banks as the lenders and the clients as the borrowers, or depositors (Shaikh, 2011). This lending scheme is suitable for providing working capital and funding for fixed asset purchases and project financing. The two types of participatory profit loss sharing models are presented in the following discussion.

The first model of profit loss sharing scheme is known as *mudarabah*. *Mudarabah* is defined as a partnership between two parties: banks that provide 100% of the capital and borrowers who provide entrepreneurial project management skills. Any profits generated are shared between the bank and the entrepreneur at a predetermined rate, while the bank bears any losses as the investor. If the losses stem from project mismanagement, the entrepreneur takes the responsibility for such losses. In this scheme, an asymmetry information risk may exist in the sense that the bank may not be able to supervise the business activities of the entrepreneurs in a consistent way. As the borrower manages the funded project independently, the scheme may also incur high monitoring costs. A study by Khalil et al. (2002) suggests that banks should select their entrepreneur partners based on their personality, financial track record and credibility, in order to mitigate this asymmetric information risk. An asymmetric information problem becomes a serious issue when banks have limited access to information about entrepreneurs’ financial performance. This issue may be due to the lack of a standardized financial statement and a possible lack in clients’ capability to prepare such financial reports (Samad et al., 2005). Therefore, when offering this borrowing scheme, banks need to ensure that borrowers provide regular and accurate reports of the project’s financial performance. Such reporting requirements may present major challenges for many small enterprises.

The second model of a profit loss sharing scheme is *musyarakah*. *Musyarakah* is defined as an equity participation contract, where banks may not necessarily be the only providers of capital. Within this scheme, two or more parties share the capital and expertise. Profits and losses are shared on the basis of the amount of capital invested. The project
can be run by one or both parties. As the return on loans on mudharabah and musyarakah schemes cannot be predetermined, the performance of these schemes is more complex to evaluate and thus have become less popular.

**The sales model**

Sales model is a trade contract, whereby one party buys an asset and sells it to other party at the original price plus a markup (Visser, 2009). The first example of the sales model scheme is known as murabahah. This lending scheme involves reselling an asset at the mark up price by a seller to a buyer on a signed contract. Under this contract, both seller and buyer must agree on the mark up fee required by the seller. The buyer may pay for the purchased assets immediately, at the end of agreed period, or on an installment basis. This scheme is usually used to finance the purchase of working capital assets such as raw materials, machinery and equipment (Khan, 2008). One of the distinctive features of murabahah, also known as bai’ al muajjal, is that repayment of the loan can be deferred to a future date.

In contrast to participatory risk sharing lending schemes, the sales model is the least risky scheme of transaction and as such has emerged as one of the most popular financing schemes. The popularity of this scheme is due to a number of possible reasons. Firstly, as this scheme eliminates the borrowers’ written reporting obligation; it is more acceptable and suitable for clients with limited literacy skills. Secondly, since this scheme is intended solely for asset based investments, thus the possibility that funds may be misappropriated can be reduced. Lastly, this model offers lower administrative costs compared to the participatory models. As such, this scheme is suitable for providing investment assets, as well as working capital assets for microcredit schemes.

**The leased model**

The leased model is known as Ijarah, which is defined as a contract between a bank and a client whereby the bank purchases and leases equipment required by its clients for a rental fee. The duration of the lease and the rental fees are agreed in advance, with the bank retaining ownership of the equipment for that duration. Another type of ijarah is
ijarah wa iqtina, known as a ‘lease to own’ contract. In this scheme, periodic installments include a portion of the final price of an asset (Visser, 2009). By the end of the ‘by installment’ repayment period, ownership of the asset purchased through this scheme is transferred to the clients. This scheme is suitable for financing fixed assets and equipment such as machinery and motor vehicles.

**Voluntary charitable contract**

The previous three schemes, namely profit loss sharing, sales contract and leased contract, can be categorized as profitable contracts in that they aim to generate revenue for financial institutions. In addition to these profitable schemes, the voluntary charitable scheme contract, known as *qard hassan*, is also widely applied in Islamic finance. *Qard hassan* can be defined simply as an interest free loan, whereby borrowers repay the loan principal in full at the end of the agreed contract period without any returns or profit sharing paid to the lenders (Chapra, 1995). To cover the operational costs, lenders are permitted to charge borrowers administrative costs or commissions (Visser, 2009).

Originally, the *qard hassan* loan scheme was intended for charitable purposes, such as to help the needy and to increase brotherhood among Muslims. In many verses of the Holy Qur’an, *qard hassan* has been strongly encouraged as it will be multiply rewarded (see 2:245, 64:17, and 57:18). This scheme can be used for both everyday consumption and business production purposes. This scheme is particularly beneficial in meeting the poor’s need for financial assistance to start microenterprises. A summary of the four Islamic finance schemes discussed above is presented in Table 2.3.
Table 2.3. A summary of Islamic finance schemes

<table>
<thead>
<tr>
<th>Participatory profit loss sharing</th>
<th>Sales Financing</th>
<th>Leased</th>
<th>Charitable contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purposes</td>
<td>Predominantly fixed assets investment</td>
<td>Investment capital and working capital</td>
<td>Equipment, machinery and motor vehicles</td>
</tr>
<tr>
<td>Cost to borrowers</td>
<td>High</td>
<td>Low</td>
<td>Low</td>
</tr>
<tr>
<td>Risk to the borrowers</td>
<td>Lower if there is no predetermined minimum profit</td>
<td>Higher since the assets are owned by the institution until the last installment is paid</td>
<td>Lower</td>
</tr>
<tr>
<td>Risk to the institution</td>
<td>Higher if the client’s reporting is inaccurate</td>
<td>Lower, the institution own the asset</td>
<td>Moderate</td>
</tr>
<tr>
<td>Administrative cost of the institution</td>
<td>Higher, since PLS is more complicated</td>
<td>High initial cost to buy the asset</td>
<td>High initial cost</td>
</tr>
<tr>
<td>Enforcement</td>
<td>Requires monitoring, difficult to enforce accurate reporting</td>
<td>Less difficult</td>
<td>Less difficult</td>
</tr>
</tbody>
</table>

Source: adapted from Dhumale and Sapcanin (1998) and (Dusuki, 2008a)

Microfinance institutions can provide a wide range of financial services, including saving deposits and lending products. As discussed earlier, microfinance products are usually characterized by small transactions in rural areas, the implementation of alternative lending approaches to replace the conventional requirement to provide physical collateral, and the implementation of processes for making simple transactions straightforward. In order to adopt Islamic finance principles, a microfinance institution
has to develop products that comply with the three principles of the Islamic finance of *riba*, *gharar*, and profit loss sharing (El Hawary and Grais, 2005). A wide variety of Islamic financial instruments that noted before can be applied to microfinance ventures. The instruments can be developed into micro-saving and microcredit products as alternatives to those provided by conventional microfinance (Obaidullah, 2008).

Most Islamic microfinance institutions prefer to utilize simple transaction schemes are characterized by low risk and low return (Badawi and Grais, 2012). Micro-saving schemes can be informed and designed by several Islamic instruments such as *wadiab* and *mudharabah*. Obaidullah (2008) provides an explanatory account of how these schemes can be designed for particular purposes. *Wadiab* is a scheme for the guaranteed safekeeping of clients’ deposits by MFIs in a savings account facility. MFIs may utilize these deposits for investment purposes; any profits or losses incurred are not shared with the depositors. Alternatively, a different model of micro-saving can be given on *mudharabah* scheme. In this scheme, savings generated from the poor will be used by the institution for financing and investment purposes. In the event of a profit being made, the bank will share this with the depositors, but where losses are incurred, the bank takes responsibility for these.

Popular micro-savings products are usually characterized by high liquidity and locally focused design (CGAP, 1997). The poor require a secure and convenient savings deposit facility without the conditional imposition of a limited minimum balance. Due to their high investment risk and low liquidity, savings products under a *mudharabah* scheme are less suitable for microfinance purposes. Conversely, the *wadiab* scheme is considered to be the most suitable instrument for micro-saving as it only requires small balances and can offer high liquidity.

Micro-credit is the major service of microfinance. Islamic microfinance can adopt the application of the group lending mechanism and joint liability to pressure debtors to repay their loans and reduce the likelihood of non-performing loans by sharing borrowing responsibilities. The Hodaidah Microfinance program in Yemen successfully implemented this approach by asking the credit applicant to form a group consisting of five people who would agree to guarantee repayment of the loan and who would encourage each other to repay the loan on time (UNCDF, 2002).
The practices of participatory profit-loss sharing financing, sales model and voluntary charity financing are all applicable to provide a microcredit scheme. In practice, the sales model using *murabahah* instrument and *bai’ al muajjal* are more popular due to their straightforward loan application processes. Once a loan is approved, the institution will provide the borrower with the required assets and resell such assets with a markup fee. Finally, a contract between the borrower and the institution will be signed indicating the agreed price, the repayment period and the installment amount. Both microfinance institutions and their clients need to fully understand the loan contract conditions including the acquiring price, the mark up fee and the installment payment period.

The profit loss sharing scheme, under *mudharabah* and *musyarakah* schemes, is also applicable and appropriate for microcredit purposes, yet it is more suitable for microfinance clients with more stable business revenue. In this scheme, microfinance and micro-entrepreneurs are considered partners. In the case of *mudharabah*, microfinance institutions will provide the total funding for micro-entrepreneurs, while the micro-entrepreneurs provide project management skills. Any profits are shared on a predetermined ratio; any losses are borne by the lender. For this reason, *mudharabah* is considered a risky lending option due to the uncertainty around both the likelihood of any profits being generated and the accuracy of any profit figures reported by the borrowers (Khan, 2008). In the case of *musyarakah*, both the microfinance and micro-entrepreneurs share any profits arising on the basis of the amount of capital invested. The main challenge in adopting this scheme in microfinance is that a *musyarakah* scheme requires intensive and time consuming project monitoring that may come at a high cost. Another challenge in *musyarakah* practice is the possibility that a lack of record keeping expertise and inaccurate profit reporting by the borrower that can lead to an agency problem between borrowers and lenders.

The voluntary charity mode is also widely implemented in microfinance. This mode is suitable for assisting society’s poor to improve their wellbeing and quality of life, as anticipated outcomes of their participation in small business ventures. The loan can be used as startup funding and to empower the poor by providing subsidized skills training. *Qard hasan* is the main instrument used by the case study institutions at the center of the research reported in this thesis. Since the institutions are funded by charity, all products
and services offered by the institutions adhere to a voluntary charitable contract that excludes profit seeking intentions. The issue of sustainability comes into question where the sole focus is in low return loans. This voluntary charity model will be the main focus of discussion in this thesis. The key strengths and weaknesses of each of the Islamic microfinance instruments discussed are presented at Table 2.4.
Table 2.4. The application of Islamic finance scheme to microfinance

<table>
<thead>
<tr>
<th>Type of product</th>
<th>Islamic finance instruments</th>
<th>Strengths</th>
<th>Weakness</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro-saving</td>
<td>Wadiah</td>
<td>The amount of deposit is guaranteed by the institution</td>
<td>No financial return to depositors</td>
</tr>
<tr>
<td>Qard hassan</td>
<td>Simple and easy to implement</td>
<td>No financial return to depositors</td>
<td></td>
</tr>
<tr>
<td>Mudharabah</td>
<td>Encourages partnerships between MFI and its clients</td>
<td>No principal/ deposit amount guarantee</td>
<td>The depositor is responsible for all project losses</td>
</tr>
<tr>
<td></td>
<td>High return in the case of profitable project projects</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Micro-credit</td>
<td>Murabahah and Bai al Muajjal</td>
<td>Simple and easy to implement</td>
<td>Mark up fee can be seen as similar to conventional banking interest rate rates, therefore, the institution has to make sure the sharia compliance of its product</td>
</tr>
<tr>
<td></td>
<td>Clear contract between MFI and its clients</td>
<td>High initial cost for microfinance</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Asset backed transactions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mudharabah</td>
<td>Encourages partnerships between MFI and its clients</td>
<td>Lack of accurate bookkeeping and misreported profit from microfinance clients</td>
<td></td>
</tr>
<tr>
<td>Losses belong to the MFI</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agency problem</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Muzarakah</td>
<td>Sharing of risks and returns</td>
<td>High monitoring costs</td>
<td></td>
</tr>
<tr>
<td>Encourages partnerships</td>
<td>Inaccurate profit reporting by clients</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agency problem</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
2.2.2.3. The application of Islamic finance

Although scholars generally share similar viewpoints on the question of the integration of Islamic microfinance with Islamic charity, they propose the implementation of quite different models. While some argue that Islamic microfinance practices need to be part of those within mainstream financial institutions, others argue that Islamic microfinance should only be conducted by non-bank financial institutions.

Originally, Islamic banking was developed to achieve Islamic economic objectives of equality and justice. However, history has seen a mission shift away from these humanistic objectives towards profit maximization. A study by Mollah and Uddin (2012) argues that Islamic banks do not engage in microfinance because of their belief that the poor are not creditworthy. Providing microfinance services will endanger financial performance of Islamic banks. However, other scholar believes that Islamic banking should be more concerned about the achievement of Islamic economic objectives rather than about profit maximization only (Segrado, 2005). By entering into the microfinance sector, Islamic banks may play a more effective role in distributing wealth in ways congruent with Islamic microfinance’s original mission and objectives (Rahman, 1999).

Abdul Rahman (2007), Dhumale and Sapcanin (1998) and Dusuki (2008a) strongly suggest that microfinance should be delivered by commercial Islamic banking. Islamic microfinance practices could also inform Islamic banking’s social responsibility program (CSR) (Segrado, 2005). Excessive liquidity in Islamic banks could be used for socially responsible investments in microfinance ventures (Dusuki, 2008b). Islamic banks also could take advantage of the well-established wide network of banking branches for more efficient and effective delivery of microfinance products and services. Although some skepticism exists about the current profit maximization motives of Islamic banking,
Dusuki (2008a) suggests that Islamic banking may reduce risk occurring in serving the poor by delivering microfinance through a special purpose independent entity. Additionally, financial reporting of this entity should be separated from the main financial reporting of Islamic banks.

Wilson (2007) offers an alternative view that microfinance is best provided by non-banking institutions. Wilson suggested a *wakalah* model in which microfinance institutions link to *zakat* and other charitable institutions. He argues that the delivery of microfinance products and services through the mainstream banking system will undermine the historically established social justice role of microfinance in poverty alleviation. His argument is supported by Abdul Rahman (2007) who asserts that microfinance could not be delivered by mainstream banking services. In a similar vein, Hassan (2010) suggests microfinance institutions could be developed as non-government organizations (NGO) that raise funds through commercial and charitable finance entities.

Compared to the overall microfinance industry, Islamic microfinance remains a small player in its capacity and capability to achieve its dual objective of achieving sustainability and outreach. Karim et al. (2008) argue that Islamic microfinance has the potential to expand its financial reach in response to strong demand for Islamic microfinance products worldwide. For example, in Yemen Islamic microfinance products and services are preferred by 40% of the country’s poor regardless of the borrowing costs. In Syria, religious values represent the major obstacle facing the poor in their attempts to gain access to microfinance products and services. In Indonesia, a survey of Bank Indonesia on banking preference reveals that 49% of its respondents in East Java prefer to access Islamic, rather than conventional, finance (Seibel, 2008). From the research findings reported above, it would seem that Islamic microfinance has the potential to develop into a network of strong financial institutions that provide products and services for the Muslim poor worldwide.
2.3. Literature gaps: subsidy, religious charity and microfinance performance

Previous sections have presented the development of microfinance since its initiation to its current growth. Despite the idea of microfinance commercialization, many microfinance providers still continue to take advantage of subsidy in various forms including charitable donations. Remarkably, literature discussing the impact of subsidy on microfinance performance is limited. Important exception works including D’Espallier et al. (2013), Armendáriz et al. (2011), Hudon and Traca (2011) and focus on the effect of subsidy on microfinance performance and come to different conclusions.

The proponents of using subsidy for microfinance’s funding assert that, at a certain level, MFIs who receive subsidies are more efficient and have better social performance than MFIs who do not receive subsidies (D’Espallier et al., 2013, Hudon and Traca, 2011). Subsidy is particularly needed when MFI aims to serve the poorest (Frankiewicz et al., 2011). It is used to cover start-up expenses and other expenses related to institutional capacity building and product development. Morduch (2005) argues that subsidy will benefit microfinance performance as long as it is strictly regulated and designed at a certain amount and time.

In contrast, the opponents believe that subsidy’s dependency will undermine MFIs’ efficiency and professionalism. There is plenty evidence showing excessive used of subsidy have caused MFIs’ failures in China, East Asia and South America (Morduch, 2005). Further criticisms relates the availability of subsidy and MFIs’ growth (Charinotenko, 2003). This argument noted that although subsidy is a type of low cost of financing; the competition to access such funds is high. It is neither easy to access nor plenty available. As such, dependency on subsidy will limit the scale and growth of MFIs (Ledgerwood, 1998).

In fact, arguments on limited subsidy seem to neglect the existence of continual charitable donations in a form of religious charity. This type of charitable donations has been and continues to be an important factor in shaping societies and cultures (Singer,
2008). It is widely evident that many faith based MFIs continuously depend on this type of charity to provide microfinance programs. The examples of worldwide faith based microfinance programs include Hope International, Islamic Relief, World Vision, and Catholic Relief Service. Particular study linking the use of religious charity on MFIs performance may open new avenues for microfinance literature.

Additionally, existing studies in the literature have not covered issues relating to potential risks that may arise from using subsidy to loan performance. From the perspective of clients, loan funded by subsidy might be seen as a type of flexible loan that may not require a strict loan repayment. This case might be true for religious charity that is commonly given as a grant for charity recipients. Observations on the impact of religious charity on loan repayment may broaden understanding on potential moral hazard problem in microfinance.

Looking particularly on Islamic microfinance literature, prominent works in the literature share similar view of using Islamic charity in microfinance. Since this religious charity is premised on sets of compliance; debates on how to utilize this charity for microfinance remains unsolved issues in the literature (Sarif and Kamri, 2009, Wan Ahmad and Mohamad, 2012, Hassan et al., 2012). The debates relating on the use of Islamic charity on microfinance will explored further in the following Chapter Three of this thesis.

2.4. Conclusion

This chapter’s literature review of the theory and practice of Islamic charity provided a basic understanding of the theory and practice of microfinance and how Islamic finance instruments are applied in microfinance practice. Islamic microfinance represents an integration of two emerging concepts: Islamic finance and microfinance. Theoretically, both concepts share similar views in relation to supporting entrepreneurial initiatives and attempting to empower the poor. Practically, Islamic microfinance scholars have suggested various Islamic transaction schemes and several models to create sustainable Islamic microfinance institutions that have broad outreach. The literature review also
unearthed findings in relation to particular strengths and weaknesses of Islamic microfinance practice.

It is argued that the wide variety of instruments in Islamic finance offer flexibility in designing micro-saving, micro-credit and other micro financial products. The literature review also found some complexities in the application of these instruments. As a key review finding, microfinance needs to design products that meet its target market’s needs as well as provide staff and prospective clients with adequate skills training and knowledge resources.

The studies reviewed in this chapter suggest that Islamic microfinance is still in its infancy. Although theory in this field has been well developed, reports of empirical Islamic microfinance evidence are rare. Lastly, this chapter presented several issues that have nor fully discussed in the literature. This thesis may contribute to the Islamic microfinance literature by investigating Islamic microfinance practice in Indonesia, particularly in relation to the integration of Islamic microfinance institutions and Islamic charitable organizations. It has been suggested that Islamic microfinance needs to be integrated with Islamic charity institutions to enhance the role of microfinance in poverty alleviation. How the integration between the two discourses, namely Islamic microfinance and charity, could be advanced will be further discussed in the next chapter.
Chapter 3

Islamic charity based microfinance: a sustainability and outreach framework

3.1. Introduction

Within most societies, various not-for-profit or volunteer organizations exist to support the socially and economically disadvantaged. The previous chapter discussed the development of microfinance institutions in relation to their objectives and shared mission to empower the poorest of the poor to lift themselves out of poverty. The chapter also discussed two microfinance paradigms: the welfarist with its focus on a socially oriented mission and the institutionalist with its focus on achieving financial sustainability. In an Islamic context, microfinance also can be classified into two types of institutions: commercially based institutions and charity based institutions. Both types of institutions complement each other and play different roles in poverty alleviation (Obaidullah, 2008).

The literature review reported in this chapter informs the development of the theoretical framework that will be used during the data analysis process as a heuristic tool to evaluate the performance of the three ICBM case studies presented in this thesis. This framework will articulate the definition of Islamic charity based microfinance (ICBM), the types and characteristics of Islamic charity that are used as funding sources of ICBM, definitions of institutional sustainability and outreach in the context of ICBM, and the key success factors that underpin the achievement of institutional sustainability and outreach.

The chapter is framed around five sections. Section 3.1 has introduced this chapter. Section 3.2 will discuss the theoretical framework of ICBM. Section 3.3 will discuss the types and characteristics of Islamic charity that can be used as funding sources of ICBM and Section 3.4 will develop a framework of ICBM institutional sustainability and outreach. The last section concludes the chapter.
3.2. The concept of ICBM

This thesis uses the term Islamic charity based microfinance (ICBM) to define a program or an institution that utilizes Islamic charity as the main source of program funding. The use of Islamic charity for microfinance programs has only recently received research attention. Habib Ahmed, Monzer Kahf, Mohammed Obaidullah and Kabir Hassan are among those who encourage the integration of Islamic charity with microfinance. Habib Ahmed’s pioneering research in 2002 focused on the performance of Islamic microfinance in Bangladesh. This study found that one of the major limitations to the growth of Islamic microfinance is the lack of available funds in the industry. The study findings recognized that Islamic microfinance has an advantage over conventional system in being able to utilize continual flows of Islamic charity to support the development of Islamic microfinance. Ahmed’s key research findings have motivated many Islamic finance scholars to pay greater research attention to generating more comprehensive data in this field of study.

In Islam, poverty reflects the inability of an individual to meet the five basic requirements in life: religion, physical and emotional wellbeing, education, offspring and wealth (Hassan, 2010). This understanding of poverty concept maintains that religion and life can be protected through the provision of basic needs, including safe food and clean water, health services and secure shelter (Ahmed, 2004). Poverty is a serious issue acknowledged in Islamic teaching. Descriptions of poverty that emphasize the importance of tackling poverty by providing food and social security for each individual in the society abound in Islamic narratives and in the practice of the Prophets and Caliphs (Akhtar, 2000). Efforts to alleviate poverty are considered in the same light as fighting for Allah’s cause and are equivalent to the efforts required to maintain fasting and prayer (Leaman, 2006). In the verses of the Qur’an, the obligation to pay *zakat* is stated thirty times with many instances associated with the obligation of prayer in the same verses (Qardhawi, 2009).

All civilizations face poverty-related problems and issues. Qardhawi (2009) examines the position of the poor before Islam in ancient civilizations such as Egypt and Babylon, noting that poverty in these civilizations emerged as a consequence of a lack of access to
arable land and other resources essential to carrying out producing activities. The poor were often sold as slaves to the rich and in such circumstances their basic needs were provided for by their owners. In the era before the rise of Islam, Mecca was characterized by an enormously unequal distribution of wealth such that large segments of its society’s poor and the needy worked for the minority elites (Ansari, 2011). It was also evident at this time that the followers of the Prophet were mostly those from the poor and disadvantaged groups in society (Bonner, 2005b, Farooq, 2008). This historical background indicated that Islamic charity has been used to address social and economic inequalities as well as to eliminate the slavery system.

Shepherd (2009) argues that equality is the most relevant concept within Islamic social teaching on modern economic development. The allocation of scarce resources and wealth transfer through Islamic charity in society exemplifies the centrality of equality concerns within Islamic teaching. Islamic charities are major funding sources that play central roles in poverty alleviation (Bonner, 2005a). In Islam, it is understood that poverty is not effectively addressed, or ‘solved’, by simply handing out money in a charitable way. Rather, Islamic charity emphasizes the need for the underprivileged poor to take the initiative to work hard in utilizing resources in ways that may raise their living standards and alleviate poverty (Akhtar, 2000). An example of how Islam encourages hard work can be seen in in Figure 3.1.

Figure 3.1: A narrative relating the significance of a work ethos in the Prophet period

A man came to Prophet Muhammad and asked for charity. The prophet said: do you have anything in your house that can be sold? The man said: yes, some clothes and a container for drinking. The prophet said: bring them to me. The prophet bought the clothes and a container and gave the proceeds to the man and asked him to use half of the money to buy food and another half to buy an axe to collect the wood and sell it. The Prophet asked him to come back after 15 days; it was evident that the man was able to generate income ten times more than he had in the beginning. The prophet than said: it is better for you than asking, as asking is only acceptable for one with the extremely poor and huge debt burden.

Source: Suttan (2012)

In relation to the Qur’an’s principles on poverty, scholars propose several strategies for poverty alleviation. Akhtar (2000) proposes three strategies for use in Islamic teachings

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2 Prophet period is define as a period when Muhammad was elected as a Prophet until when He passed away.
on poverty alleviation. These strategies relate to the fulfillment of basic needs, the enhancement of earning opportunities and the equal distribution of income and wealth through Islamic charity distribution. Taking a more pragmatic approach, Obaidullah (2008) proposes three strategies to alleviate poverty. The first strategy involves the utilization of charity to fulfil basic survival needs, the second strategy attempts to empower the poor and the third attempts to facilitate the poor’s participation in a commercial trade.

The strategies described above may enhance understanding of the role of Islamic charity in alleviating poverty. Irrespective, the distribution of charitable funds on its own is unlikely to alleviate poverty in any significant or long term way. Poverty alleviation efforts are more likely to succeed if these are directed towards empowering and encouraging the poor to participate in some form of commercial trade. The main goal of poverty alleviation is the transformation of the poor’s circumstances such that they may in the future become charity donors rather than charity recipients.

Figure 3.2. Poverty alleviation strategies in Islam

From the perspective of the Islamic charity sector, one of the crucial issues is finding effective and efficient charity distribution mechanisms that can optimize the benefits of Islamic charity for society. Research evidence from several Muslim countries shows that currently, Islamic charity is underutilized and cannot generate significant benefits for society and as a consequence, has a limited role to play in poverty alleviation (Mohammad et al., 2012). These review findings suggest that Islamic charity and microfinance can be seen as complimentary to each other and as such, in concert, have the potential to form collaborative partnerships in the distribution of charitable funding.
In addition, from the perspective of microfinance, the complimentary and collaborative use of Islamic charity and microfinance has two main advantages: it increases financial inclusion and it enhances institutional sustainability. Taking the first advantage, the poorest are excluded from the microfinance services because they are still struggling to meet their basic survival needs. Scholars argue that Islamic microfinance can utilize zakat funds to provide for these basic needs and for the funding of training to increase the skills of the poorest of the poor (Ahmed, 2007). Furthermore, Obaidullah (2008) believes that Islamic charity has a role to play in assisting the economically inactive poor to become economically active and to facilitate their greater involvement as participants in microfinance. Islamic charity can be distributed in the form of non-interest loans that can be accessed by all segments of the poor and as such, in this way could increase financial inclusion in Muslim countries.

In relation to the second advantage, the use of Islamic charity in microfinance could also enhance the financial sustainability of Islamic microfinance institutions (MFIs). Mohieldien et al. (2011) argue that the use of charity as a source of funds will reduce the financial costs of microfinance institutions and increase operational efficiencies. It has been argued that one of the main causes of high rates of non-performing loans in microfinance institutions is due to clients’ use of funds for direct consumption purposes rather than for productive income producing purposes. By using charity for taking care of clients’ basic needs, Islamic microfinance can reduce the possibility of asymmetric information and moral hazard problems and as an outcome, may lead to better loan repayment rates and increased financial sustainability (Ismail and Possumah, 2013).

There are two models of the integration of Islamic charity in microfinance: the pure charity model and the integrated model. The pure charity microfinance model uses a combination of Islamic charity funding sources to provide both social and commercial services. Zakat, as a compulsory Islamic levy, is mainly used to provide resources to enable the poor to meet their basic needs and for skills training programs, while voluntary types of Islamic charity — shadaqa and waqf — can be used to provide funds for commercial services (Kaleem and Ahmed, 2009, Obaidullah, 2008). Zakat is specifically designed to fund the provision of resources to enhance client wellbeing and to expand the capabilities of the poorest. Zakat can be used to fund social services in three key
areas: providing resources to enable clients to meet their basic needs, providing training and skills enhancement programs and providing capital grant/interest free loans for the initial capital.

The second model presents an integrated model of Islamic charity and Islamic microfinance institutions as discussed by Ahmed (2007), Obaidullah (2008) and Hassan (2010). The integrated model uses a combination of both commercial funds and Islamic charity. Commercial funds are used to finance the commercial services, while Islamic charity is used to finance social services. Islamic charity plays an important role in addressing the adverse circumstances the poorest find themselves in prior to participating in microfinance programs. Similar to microfinance institutions, the integrated model offers commercial services such as micro saving and micro credit facilities, micro-insurance, and micro-leasing using Islamic financial schemes of transactions. However, this integrated model could face many challenges in its implementation due to conflicting organizational culture, policy and regulatory framework between social and commercial functions within the integrated model itself (IRTI, 2014).

Overall the literature review highlighted significant benefits of using Islamic charity as a microfinance source of funding. However, there is little empirical research that explores these benefits. This thesis, therefore, will evaluate the ICBM institutional sustainability and outreach to provide empirical contributions to the Islamic microfinance field of study.

3.3. The types and roles of Islamic charity in microfinance funding sources

The discussion in this section is limited to an explication of the characteristics of three major types of Islamic charity collected in Indonesia: zakat, shadaqa and waqf. This discussion will emphasize the roles of each type of Islamic charity and the benefits and challenges that might arise in using each type of Islamic charity for microfinance funding sources.
3.3.1. Zakat

It is compulsory for those who have accumulated a certain level of wealth, known as *nisab*, to pay *zakat*. *Zakat* refers to the transfer of wealth from the wealthier ‘haves’ to the poor in order to facilitate the redistribution of income and wealth in the society (Kahf, 1989). In Sharia, the word *zakat* refers to the determined share of wealth prescribed by God to be distributed among deserving categories. Islam considers that all things belong to God; therefore possession has to be purified. For wealthy donors, the charitable distribution of some of their wealth in this way bring benefits such as cleanliness of the inner soul, increased wealth and for the poor, improved health and wellbeing, and financial growth (Qardhawi, 2009).

*Zakat* is one of the most regulated types of charity mentioned in the Qur’an. Islamic laws refers to several inherent characteristics of *zakat* in relation to its recipients and its distribution mechanisms. Firstly, Islam provides a clear definition of who can be a beneficiary of *zakat*. As noted in the Qur’an (9.60), *zakat* can only be given to eight categories of people: the poor, the needy, workers in *zakat* administration, newly converted Muslims, liberated slaves, those who are in debt, those who work for the sake of God, and wayfarers. Among those categories, the poor and the needy are mentioned earlier in the verse of 9:60 indicating that the primary function of *zakat* is to provide basic resources to meet the basic survival needs of the poor and the needy. According to Kahf (2006) extending relief to the poor and needy is the top priority of *zakat* disbursement. Specifically, *zakat* may be distributed to those who have little or no income, orphans, the sick, the disabled and the homeless (Obaidullah 2008).

*Zakat* is an annual compulsory levy. It must be paid directly to the eight categories mentioned above and disbursed within one financial year (Hassan, 2010). According to Qardhawi (2009), any investment, or capitalization of *zakat* funding is prohibited. Many scholars confirm that *zakat* must be paid directly when accumulated assets reach *nisab* (Wan Ahmad and Mohamad, 2012). Consequently, *zakat* becomes a one off means of assistance that is most often used to finance immediate and pressing needs of the recipients. This condition limits the role *zakat* can play in the provision of funding for longer-term poverty alleviation interventions.
Zakat can be distributed either for direct consumption or income production motives. Traditionally, zakat is distributed directly to the poor from the rich. Historically, in Indonesia, this distribution mechanism was popular with the rich as it enabled them to publicly demonstrate their wealth to poorer members of society (Abdullah, 1991). This traditional way of disbursing zakat in the form of direct cash payments to recipients has been found to have limited impact on recipients’ longer-term welfare. With generally little in the way of resources, the poor may be more likely to use any direct charitable cash payments to meet immediate consumption needs (Sarif and Kamri, 2009). Therefore, distributing zakat as productive capital in the form of productive assets is now regarded as a more powerful distribution strategy when seeking to expand the income earning capacity of the poor.

Productive zakat is a strategy whereby zakat is distributed in ways that have the potential to assist recipients to develop income generation capabilities. Productive zakat can be distributed using three key mechanisms: zakat as a grant and capital aid, zakat as source of funding for training provision and zakat as qard hassan loans (Ahmed, 2002, Hassan, 2010, Rahman, 1967, Sarif and Kamri, 2009).

Some scholars agree that zakat can play additional roles in improving socioeconomic conditions if funds are distributed for production purposes that encourage recipients to develop sustainable income generation initiatives (Hafidhuddin, 2002). The production method of funds distribution has gained popularity from the time zakat institutions first began to manage the collection and distribution of Islamic charity. For the institutions, this method of distributing productive zakat may stimulate the development of more innovative programs that can attract greater donor participation.

Productive zakat may risk compliance obligations to sharia (Wan Ahmad and Mohamad, 2012). The risk to sharia compliance can occur due to delays in the disbursement of zakat, the denial of individual rights to zakat, and the exposure of zakat funds to risk. As such, much debate surrounds issues to do with the implementation of zakat rules and regulations. Wan Ahmad and Mohamad (2012) examine the viewpoints of the classical Islamic Jurists on this debate and conclude that the allocation of zakat for productive purposes needs to consider two factors: the availability of zakat funds and the types of
recipient needs that should be prioritized. Specifically, they argue that the use of zakat in productive activities can be made when there is more than enough zakat available to fulfill the basic needs of the poor.

The most contentious characteristic of zakat is the concept of transfer of ownership (tamlik). Tamlik can be defined as the transfer of ownership of zakat from the wealthy ‘haves’ to needy recipients; whereby the recipients have full authority to own and control the use of their zakat funds for their own purposes (Ahmed, 2004, Sarif and Kamri, 2009). Tamlik will become an issue in the distribution of productive zakat in the sense that it may not only involve direct distribution but may also involve almost ‘invisible’ indirect distribution (Sarif and Kamri, 2009). For example, recipients may not receive zakat in the form of tangible assets rather as intangible assets such as knowledge and expertise gained through skills training programs. Similarly, distributing productive zakat as a qard hassan loan is also contentious in that zakat should be given directly to recipients without any specific conditions imposed on its repayment.

The Qur’an does not provide specific guidance on the application of the transfer of ownership for zakat distribution. Thus, the rule of using zakat as a loan are by the scholars’ opinion. Qardhawi (2009) and Kahf (2006) share a similar viewpoint in agreeing with the idea that zakat can only be used for interest free loans in order to assist al gharimin (people with difficult debt burdens) to repay their debts. However, neither author mentions the use of zakat for providing credit for productive activities. Similarly, Hassan (2010) suggests that zakat funds can only be used as capital grants for the initial development of a microenterprise without any expectation that the principal be repaid. Zayas (2003) strongly argues that the provision of zakat as a loan can only bring temporary relief and may actually increase the poor’s debt burden.

By contrast, the proponents of using zakat in the form of a loan argue that the concept of tamlik is not an absolute concept since it is not mentioned in the major Islamic rules. If zakat is distributed as a charitable loan, it is likely to provide many benefits to the society since repaid zakat funds can be distributed to other recipients. Thus, a greater number of poor will benefit from zakat (Hassan et al., 2012). However, zakat is required to be distributed in the form of flexible loans, where repayment of the loan is not
compulsory if borrowers are experiencing repayment difficulties. This argument is limited in that the earlier discussed notions asymmetric information and moral hazard can arise when the poor do not want to repay the loan because they see themselves as financially incapable of doing so.

*Zakat* provides for the continual circulation of free funds that have great potential as main sources of social expenditure in Islamic society. *Zakat* can reduce disparities in the economy by discouraging the accumulation of wealth and encouraging the circulation of funds (Suhaib, 2009). The study by Mohieldien et al. (2011) provides an estimate of *zakat*'s key capability to alleviate poverty in 39 Islamic countries. The researchers found that in 20 out of 39 Islamic countries, the use of *zakat* has contributed to the alleviation of poverty conditions experienced by those existing on less than $1.25 per day.

The literature review indicated a scarcity of empirical research on the role of *zakat* in poverty alleviation in the Caliphate period. The review turned up two reports on the effects of *zakat* during the reign of Umar bin Khatab (13-22H) and Umar bin Abdul Azizz (99-101H) (Ahmed, 2004). Both reports indicated that *zakat* charity funding may have played a significant role in poverty reduction as indicated by the relatively low numbers of poor people recorded in some regions of Yemen and Egypt. This observation is supported by Bello (2008) who argues that *zakat* is a major instrument that plays a vital role in ensuring an equitable distribution of wealth in Muslim society. However, the use of *zakat* alone cannot effectively address all of the underlying issues that compound the challenges poverty presents (Kahf, 1999). Kahf (1999) noted that at least three factors played into the success of attempts to alleviate poverty in Yemen and Egypt during Caliphate’s era. Firstly, both countries were rich with fertile arable lands that could produce abundant crops; second, the presence of a strong faith and reliance on God; and thirdly, the expanded market conditions and greater financial security of the population. Kahf (1999) argues further that to more effectively address social and economic problems, *zakat* needs to be complemented with other wealth redistribution strategies.

Similarly, Ahmed (2004) argues that *zakat* has a limited role in the development of poverty alleviation strategies. He maintains that *zakat* is more important for achieving
improvements at an individual needs level rather than at the macroeconomic level. *Zakat* funds can be used to address some of the contributing factors that lead to poverty at the individual level such as a lack of resources in the form of human, physical and financial capital. As such, *zakat* is expected to provide necessary inputs to generate income for the productive poor and provide periodic financial assistance for the non-productive poor. Prior study suggests that there is still only a limited role for *zakat* in the macroeconomic environment.

Although the issue of productive *zakat* is debatable, using *zakat* for *qard hassan* loans has been popular in Indonesia and Malaysia since the 1980s (Abdullah, 1991, Haron et al., 2010). Therefore, by providing some empirical evidence relevant to this debate, this thesis makes a contribution to the scarce literature focused on empirical data related to the appropriate use of Islamic charity as a microfinance funding source.

### 3.3.2. *Shadaqa*

The term *shadaqa* comes from the root word *sidq* which implies giving away goods and funds for the sake of God as an expression of faithfulness and in realization of the belief in resurrection and afterlife (Qardhawi, 2009). In modern times, *shadaqa* is more usually understood as charitable donations for those who are needy in the sake of God. Obaidullah (2008) notes that *shadaqa* may include various forms of charity, such as donations, gifts, and charitable spending.

Unlike *zakat*, *shadaqa* is the most flexible type of Islamic charity. Related verses in the Qur’an mostly discuss the benefits and advantages of *shadaqa* for the donors (QS 9:99; 34:39; 2:274), while some of verses (QS 2: 261-264) emphasize the importance of being respectful towards the recipients. The major driver in the distribution of *shadaqa* funds is the concept of *birr*, or righteousness. As such, *shadaqa* practices are more flexible and provide greater benefits for society (IRTI, 2014).

In Indonesia, *shadaqa* is more commonly given directly to intended recipients such as closest relatives or poor/needy neighbors, rather than to Islamic charity institutions. Therefore, the amount of *shadaqa* collected by Islamic charity institution is lower than the amount of *zakat*. Due to cultural values, it can be argued that the institutionalization
of ṣhadaqa faces more challenges than zakat. The increasing awareness of corporate philanthropy and corporate social responsibility as a form of service to the community has great potency to generate more ṣhadaqa via institutions.

3.3.3. Waqf

In the Arabic language, waqf means to stop, to contain or to preserve. In sharia, waqf means the holding of certain physical assets and preserving these for the long term benefit of society. Ahmed (2004) notes that waqf is a form of on-going ṣhadaqa. The difference between waqf and ordinary ṣhadaqa is that ordinary ṣhadaqa is used for direct consumption purposes; while ongoing ṣhadaqa is used to maintain the value of donated assets while the outcomes of a waqf-funded project are expected to achieve long term individual and social benefits. Islam encourages its followers to give on-going ṣhadaqa that can be used to continuously generate benefits for the society. The Prophet says: “When a child of Adam dies, his/her deeds will come to the end, except for three things: on-going ṣhadaqa, knowledge that are benefits others and a righteous child who pray for her/him”.

In comparison to zakat, waqf is not explicitly described in the Qur’an. The use of waqf is currently guided by the practices of the Prophet, Caliphs, and Islamic systems developed since the early Islamic period. This means that different interpretations of waqf exist amongst contemporary scholars. For example, in describing the characteristics of waqf, many scholars are in agreement about the importance of the concept of perpetuity. They suggest different interpretations of the definition of the perpetuity itself. Zarka (2011) notes that the only undisputable aspect of waqf is the concept of birr, or righteousness that motivates people to donate their assets permanently without expecting these to be returned.

Waqf can be divided into three types: religious waqf where the benefits are allocated for religious purposes such as building and maintaining mosques and religious organizations, family waqf, where the benefits are allocated to families and their successors, and lastly philanthropic waqf where benefits are allocated for social purposes.
Philanthropic _waqf_ is the most prevalent type of _waqf_ for the purpose of poverty alleviation.

_Waqf_ funding is characterized by two aspects: perpetuity and permanent stipulation (Kahf, 2002). The concept of perpetuity implies that donated assets should be given away on a permanent basis, whereas the revenue from invested asset is used exclusively to meet objectives stipulated by its donor. The implications of this principle are that _waqf_ assets are prohibited from being sold and _waqf_ revenues must not be transferred away from the stipulated objectives (Kahf, 2003). Kahf (2003) also agrees with the concept of temporary _waqf_, which means holding assets for a certain period in order to provide recipients with recurring benefits. The provision of scholarships to fund recipients’ academic study up to graduation is an example of temporary _waqf_.

The role of _waqf_ in social development can be seen throughout Islamic history (Mannan, 1999). Islamic history evidences several practices of using _waqf_ for both religious duty or for welfare enhancement purposes (Ahmed, 2004). In the early period of Islam, _waqf_ funds were predominantly used for religious purposes. For example, the first _waqf_-funded property documented was a piece of land in Quba Madinah that was purchased by the Prophet to develop the first Mosque. Meanwhile, the use of _waqf_ funds for welfare enhancement first arose during the Caliphate period of Umar bin Khatab and Utman bin Affan. Over this period, _waqf_ was used not only for religious purposes, but also for providing tools that could be used for increasing the capacity of the poor to generate their own income.

Evidence shows that in early Islamic society _waqf_ made a significant contribution to the economy. For example, in several countries such as the Republic of Turkey, Egypt, Iran, and Tunisia, a significant proportion of cultivated land constituted part of the _waqf_ funded asset base (Kuran, 2001). In these countries, _waqf_ has played important roles in various sectors including religion, education, and health. The _waqf_ finance system has also supported many economic sectors and has become the primary vehicle for financing Islam as a society (Kuran, 2001). For religious purposes, _waqf_ is used to finance the establishment of mosques, to cover mosques’ operating costs, and to pay the salaries of imam and religious teachers. It was evident that in the Middle East some architectural
precincts that symbolize Islamic religion were financed through waqf funds (Kuran, 2001). Further evidence shows that waqf has made significantly contributions to education. For example, the educational institutions Al Azhar University in Egypt and Oxford University’s Merton College were financed by perpetual endowments that accord the concept of waqf (Islamic relief, 2013). Furthermore, waqf also supported the development of hospitals, orphanages and shelters, and served a wide range of social functions (Kuran, 2001). A health-related example of the use of waqf is the establishment of the Shishli Childrens Hospital in 1898 (Kahf, 2003).

Historically, the predominant asset base of waqf was comprised of fixed assets, characterized by a low degree of liquidity, such as lands, books, and agricultural machinery (Kahf, 2002). Over recent times, the use of cash waqf, introduced by Mannan (1999) through the Social Investment Bank in Bangladesh, has grown in popularity as a more liquid and flexible asset within the waqf financial system. Cash waqf is not a new form of Islamic Charity. It constituted the most dominant form of waqf during the Ottoman Empire in the early 15th and 16th centuries (Cizakca, 1998). The cash waqf mechanism is used in instances where the individual donates a certain amount of money and distributes this for pious purposes. Cash waqf is distributed in two forms: cash waqf that is used directly for free lending and cash waqf that is invested with returns on investments given back to the beneficiaries (Ahmed, 2004). During this period, cash waqf was used for microfinance initiatives; funds collected were lent to borrowers who used their houses as collateral. The borrower would stay in the house and pay a rental fee to the waqf institution. When the loan was fully repaid, ownership of the house was transferred back to the borrower (Ahmed, 2004).

In the modern world, waqf in the form of cash could be collected from various sources. Cizakca (1998) proposed that commercial banks and joint stock companies could collect cash waqf. Commercial banks could invite their depositors to donate some of their deposit to cash waqf that would then be distributed as mudharabah financing. In joint stock companies, shareholders are encouraged to donate some of their shares in the form of cash waqf so that the returns on these can be used for pious missions. As cash waqf offers high liquidity, it can be readily distributed for various purposes, including as a source of microfinance funding. Islamic jurists agree that waqf funding offers flexibility
in its allocation as it can be distributed for both religious and secular purposes, and to both Muslim and non-Muslim beneficiaries (Kahf, 2006).

Research into ways *waqf* proceeds were allocated in Turkey in the 18th century revealed that 29% of funds were allocated for religious purposes, 25% for schools, with the remaining 46% for secular purposes (Kuran, 2001). In the contemporary world, Hasan and Abdullah (2008) revealed that most of the funds were allocated for religious functions. Their research, conducted in several *waqf* institutions in Johor Malaysia, shows that 56% of the total of 2477 *waqf* owned properties are utilized for mosques and other praying venues, 20% for education, 16% for cemeteries, with the remainder being used for general purposes. The research data shows that only a small percentage of *waqf* funds are directed towards poverty alleviation. This finding raises an issue worthy of future attention in relation to the potential strengths and challenges of mobilizing *waqf* assets for improving the welfare of the poor in current times.

The previous discussion shows that *waqf* can offer greater flexibility in its utilization and has the potential to be utilized as a source of funding to alleviate poverty alleviation. However, there are many challenges in utilizing cash *waqf* for poverty alleviation as documented by some studies. For example, Affandi and Nufus (2010) argue that the collection and allocation of cash *waqf* in Indonesia is still both ineffective in achieving anticipated outcomes and underutilized as a microfinance funding resource. Other researchers have identified problems with the use of *waqf* funding such as a lack of trust in existing government institutions’ capabilities in relation to managing cash *waqf* funds and controlling their investment activities, a serious lack of transparency and accountability, and a lack of managerial professionalism (Masyita et al., 2005, Ihsan and Ibrahim, 2011).

Overall, the three types of Islamic charity have distinctive characteristics and distribution mechanisms. *Zakat* has stringent regulations in relation to funds utilization and distribution. In contrast, *shadaqa* and *waqf*, as voluntary types of charity, are subject to less regulation and are more flexible in their implementation. Funds provided by *waqf* and *shadaqa* can be distributed for both religious and secular purposes and can also be invested and utilized for any righteous purposes. Although each Islamic charity has
distinct advantages and limitations in relation to their distribution, these charities can complement each other as funding sources for poverty alleviation programs. *Zakat* and *shadaqa* funds are particularly suitable for financing the design and implementation of poverty alleviation initiatives through income distribution and wealth transfer strategies. By contrast, the *waqf* – the perpetual charity, is better suited to long term investment strategies that have the potential to address non-income-related issues facing the poor such as those around health, education, physical resources, and employment (Hassan, 2010). The next section further discusses the use of Islamic charity in microfinance.

### 3.4. Sustainability and outreach of ICBM framework

The characteristics of ICBMs that utilize philanthropic funds to serve a social mission are more similar to those of non-profit institutions rather than to financial institutions. It is a common understanding that evaluation of the performance of non-profit institutions is complex particularly in instances where performance standards are intangible. This is the main reason why Drucker (1990) questioned the indicators of non-profit performance analyses in his theoretical work on managing non-profit organizations. Compared to the private institution that works for shareholders to maximize share values, the non-profit organization is developed mainly for serving a specific mission and for meeting particular social objectives. Further, the non-profit organization works on a voluntary basis frequently at no cost to clients. The key reason for the existence of non-profit organizations is to accomplish particular social missions.

Despite an abundant literature on the subject of performance analysis of commercial microfinance, the theory of performance analysis in the domain of non-profit microfinance is relatively underdeveloped. The methodology applied in the non-profit microfinance organizational sector is usually directly adopted from mainstream microfinance methodologies. For non-profit microfinance, by contrast, few studies have investigated the influence of the type of institution on sustainability and outreach indicators (see Downey and Conroy, 2010, Cull et al., 2007, Mersland and Reidar Oystein, 2007). These studies’ findings assumed that non-profit microfinance institutions will be more focused on the achievement of their social mission rather than on any measures of financial sustainability. Interestingly, these study findings did not
support this assumption nor confirm that the organization type has little influence on the institutions’ sustainability and outreach performance. While many studies mentioned previously adopted a mainstream quantitative methodology for evaluating financial sustainability, the study by Mersland (2011) used a qualitative approach in its comparison of non-profit microfinance institutions within the European Saving Cooperative. The adoption of a mainstream methodology for analyzing organizational performance in non-profit settings may face some limitations, such as the use of subsidy as sustainability indicators, high reliance on accounting data and the high reliance on quantitative methodology.

As discussed in Chapter Two, information about an institution’s dependency on subsidies is commonly used as a microfinance sustainability indicator (Ayayi and Sene, 2010). Pischke (2007) argues that the use of dependency on subsidies information as the main indicator of sustainability may be misleading as the amount and duration of the subsidy depends on the institution’s mission and objectives. The various types of microfinance institutions have different views on the use of subsidies in relation to their impact on sustainability. For example, subsidies are necessary to ensure non-profit microfinance institutions can serve their particular mission. However, the case might be different for commercial microfinance institutions that can generate sufficient and additional revenue by charging clients an interest rate on a loan.

Most evaluation of a MFI’s performance is currently highly reliant on the accuracy and timeliness of accounting data used to measure the success of microfinance institution programs. Sustainability is commonly measured by financial ratio indicators such as return on asset (ROA), return on equity (ROE) and Financial Self Sufficiency (FSS) (Ledgerwood, 1998). These ratios provide a measurement of microfinance program success calculated based on reported profitability and cost efficiencies. These ratios do not provide information related to a microfinance program’s success or otherwise in meeting its social objectives. Alternatively, as an additional measure of sustainability, Yaron (1992) introduces a Subsidy Dependence Index (SDI). This index compares annual subsidies received by the institutions with total outstanding loans adjusted to the loan yield generated by the microfinance institutions. Although the SDI considers significance variables including the total subsidy as well as opportunity cost, this
measurement is not appropriate to implement in fully subsidized institutions. Bagnoli and Megali (2011) argue that for non-profit organizations, financial performance indicators are only meaningful for measuring financial accountability. Hence, it is argued that both qualitative and quantitative studies are necessary since some aspects of institutional performance are not easily quantified.

This research adopts the performance evaluation theory of non-profit organizations to evaluate the performance of ICBM. The rationale behind this decision is centered on the assumption that ICBMs share with a non-profit organization’s distinctive mission to alleviate poverty. This mission focus stands in contrast to mainstream microfinance that focuses on financial sustainability through profits generation. This study focuses on the evaluation of the dual objectives of microfinance: sustainability and outreach. Impact evaluation is not the focus of this study since impact evaluation requires a longer time frame than this research project allowed. In what follows, approaches to measuring the performance of ICBMs are further discussed.

3.4.1. The sustainability of ICBM

The achievement of sustainability in the context of ICBMs presents unique challenges as ICBM’s services remains independent of financial incentives. In comparison to the welfarist approach to microlending that applies subsidized rates, ICBM institutions offer interest free loans using *qard hassan* mechanisms. Therefore, rather than focusing on financial sustainability, this thesis emphasizes the concept of the institutional sustainability and how this concept can be measured.

This thesis defines institutional sustainability as the ability of an institution to survive and to continuously serve its constituency (Weerawardena et al., 2010). This definition is often associated with the availability of resources to accomplish the institution’s mission. Raju (1992) argues that sustainability relates to any efforts that would provide a continuous flow of inputs, benefits and services over the long term. Similarly, Verma (1978) states that sustainability can be understood as the long term availability of resources required for achieving the institution’s long term goals. On this understanding, sustainability depends on the ability of an institution to maintain its financial capacity to
seize opportunities and respond to unexpected threats to achieving optimal operating levels and to maintain its general day-to-day operations (Bowman, 2011).

The sustainability definition focuses on the availability of resources required to achieve a sustainable institution. Charitable donations and volunteerism constitute two resources of key significance to the non-profit sectors (Greenfield, 1999). Similarly, in the context of ICBM, Kaleem and Ahmed (2009) note that ICBM sustainability depends largely on the value of brotherhood, philanthropy, volunteerism and community support. Khan’s (2011) sustainability model for ICBM, known as the Theory of Communal Viability, is established on the success story of Al Akhuwat in Pakistan in obtaining continuous voluntarism and community supports. The theory of Communal Viability suggests that the achievement of institutional sustainability depends not only on the capacity of an MFI to achieve profitability, but also on an institution’s capacity to establish and maintain long term community support relationships. Several factors contribute to the sustainability of Al Akhuwat, including beliefs that philanthropy is not a temporary act that it can be found in many parts of the world. Further poor borrowers are considered as reliable, honest, and trustworthy borrowers. In this sense, sustainability can be achieved by encouraging people realize that it is their duty to return what they borrow so that it can be used for others and that voluntarism strategies offer ways to reduce operational costs.

3.4.1.1. Achieving ICBM sustainability: key strategies

A study undertaken by Weerwardena et al. (2010) of the achievement of sustainability in non-profit organizations proposed two types of strategies at the operational level and the strategic level. At the operational level, these strategies focus on revenue enhancing and cost reduction measures, while at the strategic level, the overall organizational strategic orientation is towards the adoption of entrepreneurial schemes. Each strategy is explored below.
Enhancing revenues

The first strategy to achieve sustainability is to ensure that the institution receives a continual flow of resources to maintain all institutional operations. Non-profit organizational revenues are generally derived from diverse sources such as in-kind contributions, earnings on asset sales, sales of contributed items, and donated labor to deliver services and carry out the organization’s mission (Chang and Tuckman, 1991). Revenue can be derived from internal and external sources. From internal sources, for the most part, come from earned income from programs and services, while external sources include donations, grants, subsidies from philanthropic donations and government contributions (Chang and Tuckman, 1994).

Traditional non-profit organizations rely mainly on the income derived from donations and volunteers. Individual donations may be motivated by an ‘impure’ altruistic motive, also known as ‘the warm glow’, or the good feeling that comes as a result of altruistically-motivated participation in the provision of public goods (Rose-Ackerman, 1997). Past studies have suggested that several factors can impact favorably on the frequency, and reliability of charitable donations, and on the amounts donated. The first factor is the awareness potential donors have of the institutions and their programs (Snipes and Oswald, 2010). A donor will make their decision as to what institutions and programs they wish to direct funds to on the basis of the donor’s consideration of the institution’s mission and religious affiliations, on their own personal beliefs, and on the amount of discretionary income they have available (Gordon et al., 2010). Sontag-Padilla et al. (2012) suggested the importance of establishing non-profit branding strategies that can create a distinct institutional identity. Such strategies are likely to help the institution to communicate its social mission, build awareness within its constituency, and strengthen its competitive advantage (Herman, 2011). Along with a strong brand image, the effective communication of a clear and compelling social mission statement is an important aspect in achieving sustainability (McDonald, 2007).

In recent years, technology and social media have been used as important strategic tools to maintain the institutions’ connections with the local community. A successful example of the use of technology based fund raising marketing lies in a campaign
promoted by Barrack Obama and designed to demonstrate the benefits of integrating information technology with social networking. This campaign generated more than $200 million, with almost half of this derived from donations of less than $200. The recruitment of 750,000 volunteers, the creation of 8,000 online affinity groups, and 30,000 publicity events were key to the success of this fundraising campaign (Norquay, 2008).

The second factor that can impact on revenue generation in the non-profit organization is innovation. McDonald (2007) notes that changing institutional operating environments and market forces have prompted non-profit institutions to adopt innovative strategies in order to compete in their particular market sector. Additionally, the development of innovative practices can strengthen the institution’s competitive advantage (Porter, 1985). Innovation in the context of non-profit organization is generally focused on two strategic areas: fundraising and service delivery (Weerawardena et al., 2010). Being ‘innovative’ frequently involves the adoption of modern technologies, such as the internet (Nugroho, 2011). The use of the internet by non-profit organizations may produce various benefits such as enhancing the organization’s ability to communicate their programs internally and externally, and to more effectively and efficiently gather and disseminate information. Internet fund raising campaigns may attract greater attention and enable prospective donors to engage with the institution in ways that strengthen donor-institutional relationships (Waters, 2007).

The development of innovative fund raising strategies is receiving increasing attention in the literature. Sontag-Padilla et al. (2012) argues that more innovative ways of fundraising are necessary to reduce the dependency on traditional philanthropic sources. They propose some innovative fund raising ideas such as the implementation of relationship marketing to foster relationships with the donor by understanding the characteristics of the donors. Building good relationships with the donors through various social gatherings and annual programs enable institutions to receive continuous support towards achieving their mission (Greenfield, 1999).

Once the donor is made aware of the organization and its programs, the organization needs to demonstrate its capability to be accountable and effective in achieving stated
program outcomes in order to attract prospective donors (Courney, 2002). Prior studies suggest that donors use financial information about the institution in their decision to make donations or not (Parsons, 2007, Yetman and Yetman, 2004). Donors carefully consider the effectiveness of their contributions in realizing the institution’s social mission, particularly if they prefer to donate funds to institutions publicly known to be highly efficient and effective (Jacobs and Marudas, 2009). For example, in a large data set constructed from 6,572 nonprofit organizations, Petrovits et al. (2011) suggest that weak internal control of financial reporting will likely have adverse effects on the amount of funds donated.

A further factor influencing the continuity of support is the ability of the institutions to develop partnerships and to build community support. The development of collaborative partnerships has become a potentially powerful way to stabilize income in a dynamic and at times, volatile resource environment and where there are increasing competitive forces in the industry (Herman, 2011). Partnerships offer opportunities to expand institutional capability in serving their clients in ways that improve customer access, reduce initial costs, enhance access to additional resources, and improve institutional credibility (Kitzi, 2002). Partnerships can be formed as strategic alliances between profit and non-profit organizations.

In addition, the sustainability of the institution can be strengthened by gaining community support (Khan, 2011, Kaleem and Ahmed, 2009). Community support for non-profit organizations can be gained from community leaders and broader community involvements. The community may become involved in an institution through such roles such as volunteering, advisory committee and governing board membership (Inglis et al., 1999, Lipsky and Smith, 1989). By identifying community assets, including community leaders, gaining local knowledge and wisdom and by becoming more aware of effective community-oriented communication methods and strategies, institutions may be better able to understand needs in the community and recognize opportunities to meet these (Kretzmann et al., 2005).

The adoption of social enterprise methods has also been suggested as an effective strategy to enhance revenue flows (Peredo and McLean, 2006). Recent arguments in
non-profit organizational discourse have intentionally exhorted actors in the industry to become social entrepreneurs and to adopt more business like management strategies within the non-profit sector. Other studies have suggested the use of earned income strategies to achieve organizational sustainability, by combining non-profit with for-profit unit features. The profit generated could be used for enhancing the ability of the institutions to promote their mission to their stakeholders. Peredo and McLean (2006) cited the Grameen bank as a successful social enterprise model of how not-for profit and profit making institutions can operate in collaborative and sustainable ways.

Cost efficiency

Creating financial services for a low income population is a high-cost and high-risk endeavor. Such services inevitably attract high costs because poor people usually live in remote areas which are difficult to access and that incur high operational and monitoring costs. Furthermore, these services are high risk due to uncertainty regarding the ability of the poor to meet their future loan repayment obligations. These are some of the main reasons why the commercial banking institutions are reluctant to serve the poor.

To be sustainable, MFIs undoubtedly need to cover their operational and lending costs. If these costs are not covered, the institutional capital will be quickly depleted thus jeopardizing the MFI’s institution’s survival and very existence. Littlefield and Rosenberg (2004) argue that MFIs can achieve sustainability by charging adequate interest rates and by practicing secure loan management. In this case, charging interest is not possible as the ICBM institution offers interest-free financing only.

One of the important strategies toward achieving sustainability is to control costs effectively. This suggests that the organization must have an effective financial management system in place that can monitor budget expenditure, income and revenue flows, cost composition, and other possible fluctuations. More importantly, this type of microfinance must strive for cost efficiencies. Al Akhuwat suggests that cost efficiencies and reductions can be gained through mobilizing volunteer support (Harper, 2012). The founder of Al Akhuwat emphasizes that volunteerism upholds the whole spirit of the institution (Ghaffari et al., 2011). Interestingly, voluntary work is mostly found at senior
staff levels rather than in the junior staff ranks. This arrangement may better maintain the commitment and loyalty of junior staff members who may be hopeful of more employment.

As another strategy, Al Akhuwat recommends to reduce operational costs is by utilizing worship places such as mosques and churches to conduct loan disbursements, to make loan repayments and to conduct group meeting activities (Ghaafari et al., 2011). It is argued that the use of worship places for microfinance activities is not only important to reduce overall operational costs, but attendance at these locations may also increase clients’ moral obligation to repay their loans (Zaheer, 2011). Furthermore, management of the organization is simplified by having modest sparsely furnished offices, not owning company vehicles, encouraging staff to use either public transport or their own motorcycle with some reimbursement of costs, and by administering loans through senior staff members (Jawad, 2011). This pared-down structure contributes to the efficiency and sustainability of Al Akhuwat.

Another specific factor that contributes to the sustainability of microfinance is the ability to encourage borrowers to repay their loans on time (De Crombrugghe et al., 2008). Higher rates of repayment enable the institution to continuously provide loans without reducing the capital base of the institution. To ensure higher rates of repayment, microfinance relies heavily on social collateral (Ismail and Possumah, 2013, Ahmed, 2007). Furthermore, providing loans as capital assets rather than cash is preferable to avoid the diversion of funds for consumption purposes rather than for productive income-related activities.

3.4.2. ICBM outreach
3.4.2.1. Who should be the clients of ICBM?

The broad segmentation of the microfinance industry sector into profit and non-profit sectors influences the types of the clients institutions attempt to attract. A study by Nugroho (2010) evidences microfinance market segmentation of microfinance providers operating in Indonesia. Nugroho’s study found that in Indonesia formal microfinance institutions target the more financially well off. That these institutions’ loan contracts require prospective clients to provide sound financial reports, business
investment plans and collateral, automatically excludes the poor and poorest members of society. This means that the poor, a significant proportion of potential borrowers, cannot access existing microfinance institutions in Indonesia.

A 2010 World Bank study indicates that less than half the population in developing countries and less than one in five households have access to a bank account or other financial services (The World Bank, 2010). In Indonesia, one-third of the population find themselves financially excluded (The World Bank, 2010). This section of the population has limited education, and generally lives outside of Java Island. Lacking income and collateral, there is less possibility existing formal microfinance institutions would offer these people a loan in order to assist them to improve their quality of life through the financing of small scale income producing enterprises.

This thesis thus argues that ICBM should play a greater role in providing services for socially and economically disadvantaged prospective clients. The use of Islamic charity funding sources would enable the institutions to extend financial services to the poorest of the poor (Mohieldien et al., 2011, Ahmed, 2002). Similarly, Meyer et al. (2000) argue that institutions that use public resources intended to help the poor carry an obligation to ensure that these resources are directed towards the needy poor. From this background and context, it is proposed that ICBM institutions that benefit from Islamic resources have an obligation to serve the poor and the poorest rather than more financially secure clients. This becomes the proposition that will be tested in the case study research reported in this thesis.

**3.4.2.2. Client’s exclusion factors**

Financial exclusion is one of the major factors that inhibit the poor from being able to actively participate in the economic development process. Financial exclusion is defined as a situation where a proportion of the population has limited access to mainstream financial services (Warsame, 2009). This situation poses constraints on the ability of the poor to acquire assets, start a business, finance their emergency needs and enhance their overall standard of living (Zeller and Meyer, 2002). The implications of financial exclusion not only include financial consequences, but also adverse social consequences
that push the excluded further into the poverty cycle. Financial exclusion has been cited as one of the obstacles to the achievement of the first six out of the eight Millennium Development Goals (MDG) 2015 (Morduch, 2002). Equitable access to appropriate financial services means the poor have opportunities to accumulate assets, generate more securely income, and invest in their children’s education. An empirical study by Beck and Demirgüç-Kunt (2008) shows that countries with socially inclusive financial systems experience faster rates of reductions in the proportion of the population living in poverty.

There are several theories describing why the poorest are excluded from microfinance. Exclusion may result from institutional lending policies as well as through the poor’s own decision making (Simanowitz and Walter, 2002b). Beck et al. (2007) argue that the poor may choose to exclude themselves from accessing financial services for specific cultural or religious reasons, perhaps because of a lack of confidence and capability, or because they do not consider they need such services.

Cultural factors may constitute significant barriers to financial inclusion. Several studies have explored the importance of the need for MFIs to gain a greater understanding of culture in order to extend their outreach. For example, Shankar (2013) contends that cultural barriers arise from mistrust of banks due to an individual’s negative experiences and perceptions or due to a lack of financial literacy. This contention has overlooked the values and cultures of the society itself. There are various specific values and norms in the society that can influence the poor’s decision to participate or not in the financial market. For example, Hendricks (2000) found that the culture of polygamy is part of a common tradition in rural communities in Ghana. As such, how microfinance deals with these family arrangements becomes a concern in the lending decision process. Other studies also discuss the influence of a patriarchal society on access to and use of microfinance funds. In an empirical study, Zhao and Wry (2011) argue that when a patriarchal culture is strong, it will hinder microfinance’s outreach to women. Similarly, male interference in loan arrangements has been argued as one of the most difficult challenges in working with women clients. Challenges include men’s resistance to women obtaining credit and their possible instrumental use of women to obtain credit for their own purposes (Burjorjee et al., 2002). The poor’s own level of self-confidence
and self-esteem, and how they see themselves in society will also play into their decisions to access microfinance services, or not (Dhakal, 2004).

In addition, there is research evidence that religious values have also constrained people’s participation in financial services. Around three-quarters of people living in Muslim countries do not use formal financial services as conventional financial services apply interest rates to both lending and savings deposits (Karim et al., 2008). In a Moroccan case study, people are reluctant to participate in microfinance because they believe that microfinance is similar to usury practice in which a fixed predetermined rate is applied to both lending and savings initiatives (Allaire et al., 2009). Microfinance’s consideration of cultural contexts is regarded as one of microfinance’s success factors.

In addition to the poor who voluntarily exclude themselves from any participation in microfinance, there are a number of poor who are involuntarily excluded due to structural issues. Potential clients’ geographical remoteness, a lack of infrastructure, client eligibility and loan affordability have been identified as the major structural issues relevant to the poor’s financial exclusion (Beck and Demirgüç-Kunt, 2008). Most frequently, structural barriers arise from the formal financial institutions’ requirements for proper documentation for identification purposes, service fees and stipulated minimum account balances.

Interestingly, several studies also note that the failure of MFIs to serve the poor may be due to unintentional and inappropriate policies of the institution related to their target marketing and loan product design (Simanowitz and Walter, 2002b, Armendariz and Labie, 2011). Some institutions, for example, require prospective clients to have existing microenterprises before applying for a loan. These institutions unintentionally determine certain eligibility criteria that are not appropriate for the poorest’s circumstances (Dhakal, 2004).

Other reasons for financial exclusion may come from inappropriate products and services that are not suitable for prospective clients. For example, Armendariz and Labie (2011) show that loan products designed for women that usually require weekly repayments, have savings facilities with limited withdrawal options, and provide limited health insurance, fail to address the needs of the clients. Further, research suggests that
the majority of the clients are petty traders who face high uncertainty and unpredictable incomes. As such, they may prefer loan arrangements that enable them to make daily loan repayments after sales are completed and that offer more flexible savings products.

In addition, exclusion can also result from the client selection process. Lending staff may have incentives to exclude the poorest due to perceptions that they will be problematic in ways that might increase the work burden (Dhakal 2004). Some employee performance incentives focused on the ability to meet certain targets in relation to ‘signing up’ clients and repayment rate may encourage staff to exclude the poorest of prospective clients. This study strongly argues that these exclusionary practices need to be addressed in order to successfully facilitate wider inclusion of the poor in microfinance programs.

To ensure that microfinance is able to include the poorest of the poor, there are two aspects that need to be carefully managed: the targeting of poverty and the design of appropriate loan products and services. Appropriate targeting has been cited as the first and foremost factor to optimize the ability of microfinance to reach the poorest (Hashemi and Montesquiou, 2011). Accurate targeting attempts to ensure that the financial services only reach eligible households. There are several decisions to be taken into account to achieve effective client targeting: what will constitute valid and appropriate eligibility criteria of prospective clients, how to implement an appropriate targeting methodology, and deciding on the types of efforts needed to enhance institutional service commitments to the poor.

Decisions related to developing the most appropriate, acceptable and feasible loan eligibility criteria to apply to loans offered to the poor are central to microfinance debates in the literature. Some institutions, for example the Grameen Bank and the BRAC, use relatively simple criteria such as land ownership to select their clients. These institutions require prospective clients to have less than 50 decimals (0.5 acres) of land (Meyer et al., 2000). Other indicators such as education level and minimum caloric intake are also commonly used as loan criteria. (Hossain, 1995) found that land ownership provides an accurate prediction of an individual’s, or family’s poverty level. Using Bangladeshi data, he found a high correlation between land ownership and
poverty (Hossain 1995). In addition, a study by Wodon (1997) indicates that education levels have consistently become a more reliable poverty indicator than land ownership in urban areas, while land ownership is a more reliable indicator in rural areas. However, that there is evidence of many cases of inappropriate targeting suggest that weaknesses in the determination of eligibility criteria remain (Meyer et al., 2000).

The creation of customer-oriented microfinance services has been suggested as a strategy to increase the financial sustainability of the institution (Dunn, 2002, Woller, 2002). The idea behind customer-oriented microfinance is that products and services offered should be tailored to the needs and wants of poor clients. Currently, MFIs have begun offering not only microcredit, but also additional products such as savings instruments, emergency loans, education loans and insurance. The rationale that microfinance clients may need more than just financial products is built on the assumption that additional non-financial related services may be required to support their businesses and daily lives. Armendariz and Labie (2011) argue that the major constraint facing microfinance institutions is their lack of capacity to effectively target their market to ensure there is a good fit between their microfinance products and services and the particular and distinctive needs of their prospective clients. From the research evidence, it would seem that MFIs need to conduct sound and comprehensive target market research before appropriate microfinance products and services can be designed and implemented.

3.5. Conclusion

This chapter’s literature review informed the development of a theoretical framework of ICBM to be used in this study to analyze the ICBMs’ sustainability and outreach. Firstly, the chapter discussed three types of Islamic charity and its utilization in poverty alleviation. It found that the concept of poverty alleviation in Islam emphasizes the importance of generating income through hard work and enterprise, not simply by the distribution of charitable funds. In this sense, distributing Islamic charity for targeted microfinance initiative would enhances and enlarges the potential benefits of charity to wider society.
The framework of ICBM sustainability and outreach was developed using a non-profit organizational approach. The rationale is that ICBM relies predominantly on donor funds to establish its poverty alleviation mission. ICBM sustainability is measured by the concept of institutional sustainability which is the ability of the institution to survive and continuously serve its constituents. Its sustainability is influenced by the ability of the institution to enhance its revenue streams, to achieve efficiencies and to adopt successful enterprise schemes. Key success factors that need to be taken into account include the development of innovative product and services, accountability measures, volunteerism opportunities and donor awareness raising strategies, supportive community partnerships. The concept of outreach in ICBM is defined as the ability of ICBM to provide financial services for the poorest of the poor. The ability of the institution to attract prospective clients as well as to design appropriate products to meet client needs. The next chapter will present the methodological approach selected to respond to the research questions related to ICBM's institutional sustainability and outreach.
Chapter 4
Research methodology and data analysis

4.1. Introduction

The previous chapter discussed and developed the theoretical frameworks used in this study. This framework will be applied to three Islamic charity based microfinance (ICBM) providers in Indonesia in an attempt to examine the sustainability and outreach of these institutions’ microfinance programs. The main proposition to be tested in this examination is that microfinance has a greater chance of being sustainable and more inclusive of the poorest members of society if Islamic charity is used as a significant source of funding.

The objective of this chapter is to discuss the study’s research methodology in relation to the use of quantitative and qualitative approaches to data collection and data analysis. This chapter is structured as follows: Section 4.2 explicates the overarching methodology for this study; Section 4.3 explains the case study selection method; Section 4.4 presents data collection methods; Section 4.5 illuminates methods of data analysis and Section 4.6 discuss data triangulation strategies used and the last section concludes this chapter.

This research required low risk ethical clearance. The ethics application for this research has been approved by the Faculty HEAG under the terms of Deakin University’s Human Ethics Committee (DUHREC) to undertake the project from 20/06/2011 until 20/06/2015.

4.2. Research methodology

The overarching research methodology selected to respond to the research questions and to test the main proposition is a case study methodology. Yin (2009) notes a case study is a way to clarify a decision or set of decisions that take into account why the decisions were taken, how they were implemented and with what outcomes. In this research, the decisions relate to the use of Islamic charity in microfinance program.
The use of a case study methodology can be justified for microfinance research as microfinance, particularly in Indonesia, has diverse characteristics that may be difficult to generalize to other microfinance context (see Seibel, 2008). For example, Sakai and Marijan (2008) show that some financial cooperatives in Indonesia have performed well with respect to their profitability and sustainability although the overall industry is in decline due to the complexity of government regulations. To date, the success of these microfinance organizations has been driven by specific organizationally unique and distinctive factors such strong effective leadership and dedicated employees. In this case, case study is an appropriate methodology for this study since it allows in-depth analysis on multiple data sources and methods to explore and investigate a specific issue (Yin, 2009b).

There are three categories of case study: a critical case, a unique case, and an exploratory case (Yin 2009). A critical case is used to address key issues that have been well identified and discussed in the literature. A critical case will test the theoretical prepositions. A unique case is used to represent a unique or extreme case in which the subject areas to be explored are beyond the scope of previous research or observation. Lastly, the exploratory case is used to examine a case that may break new ground with respect to the development of new theoretical perspectives and about which there is little prior research. The research study reported in this thesis can be categorized as an exploratory study as it seeks to build on a paucity of literature related to microfinance, Islamic finance, and Islamic charities by examining the sustainability and outreach of three selected institutions that use Islamic charity as a microfinance source of funding.

Careful consideration of the design of the research study can contribute to the success of the case study approach to the extent to which data generated is responsive to the research questions. In this study, the research process was designed along two pathways. The first takes a quantitative direction through its use of researcher administered structured questionnaires to collect data from the case study ICBM clients and from non-clients, and through its use of content analysis of existing documents from each case study institution and other institutions such as Bank Indonesia, the Ministry of Cooperative and Small Medium Enterprises, the Mix Market and the Indonesian
Statistics Bureau. The second pathway follows a qualitative methodology in that semi-structured interviews are conducted with case study ICBM staff members. These interviews focus on the case ICBM’s institutional sustainability. Taken together these pathways constitute a mixed methods approach to data collection that for this particular study means that the researcher can generate multiple types of data appropriate to the research questions and to the proposition to be tested. The overall research design is described at Figure 4.1.

Figure 4.1: Research design
4.3. **ICBM institutional case selection**

The selection of the case studies forms a critical part of the research reported in this thesis. Indonesia, with the largest Muslim population in the world, is witnessing an increasingly widening application of Islamic financial services as demand for this type of finance grows. Although the Islamic financial market share is less than five per cent of the total financial market, Islamic finance, consisting of 10 Islamic banks, 23 sharia units of commercial banks, 145 Islamic rural banks and one thousand Islamic cooperative units, has reached high levels of outreach in Indonesia (Karim, 2010).

In this study, three ICBM institutional case exemplars were selected. Remenyi (2012) argues that by drawing on two or more cases, the researcher has an opportunity to compare case study similarities and differences and to evaluate strengths and weaknesses of each case. Understanding the nature of a case is important in selecting the institutional case example; whether a case can be categorized as a typical, a diverse, an extreme, a deviant, an influential, a crucial, a pathway, or most similar and most different cases (Gerring, 2007). Each different category is selected based on different research purposes and objectives. This study will select institution case exemplars that have different characteristics terms of the type of institution, its regulatory environment and the client’s coverage. Diverse cases can possibly illuminate more variations in the variables under analysis (Gerring, 2007). Diverse cases can be used for either testing the research hypothesis or for generating theory. In this study, the diversity of the cases will be scrutinized to test the outreach-related data as well as to evaluate strengths and weaknesses of ICBM sustainability. As far as possible, the selected cases for this study need to be representative of the diversity of the types of ICBM providers in Indonesia.

There are two types of institutions that have utilized Islamic charity as a microfinance funding source: *Baitul maal wat tamwil* (BMT), or Islamic financial cooperatives and *zakat* organizations. In this research, BMT Beringharjo was selected as a case representing BMT type providers because it has consistently provided social services by providing an interest free financing to low income earners since its inception in 1994 (Sakai and
Marijan, 2008, Juwaini et al., 2010). BMT Beringharjo also represents a local provider of ICBM with local coverage, Yogjakarta.

Two different types of *zakat* institutions were included as institutional cases. *Zakat* institutions in Indonesia can be divided into two major providers: government owned and privately owned *zakat* institutions. The first selected *zakat* institution, Baitul Qiradh BAZNAS was selected to represent government owned *zakat* institutions. BAZNAS provides national coverage of ICBM services. The second selected *zakat* institution, Baitul Maal Muamalat Indonesia (BMMI), represents private *zakat* organizations. Similar to BQB, BMMI also provides a national coverage of ICBM. BMMI was also selected because it has the distinction of operating its microfinance programs running within a mosque. Further exploration of this distinction may lead to expanded and deepened understandings about the cultural aspects of ICBM institutional outreach. The details of each institution and its programs will be presented in the next chapter. A summary of the case study institutions’ characteristics is presented in Table 4.1.

Table 4.1. Characteristics of the case study ICBM institutions

<table>
<thead>
<tr>
<th>Case</th>
<th>Type of institution</th>
<th>Coverage</th>
<th>Specific characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Baitul Maal Beringharjo</td>
<td>Islamic financial cooperative</td>
<td>Local institution</td>
<td>Provide commercial microfinance services along with interest free microfinance services</td>
</tr>
<tr>
<td>(BMB)</td>
<td>(social unit)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BQB BAZNAS</td>
<td>Government owned <em>zakat</em> institution</td>
<td>National coverage</td>
<td>The supervisory body of <em>zakat</em> institutions in Indonesia</td>
</tr>
<tr>
<td>BMMI</td>
<td>Privately owned <em>zakat</em> institution</td>
<td>National coverage</td>
<td>Social unit of Islamic commercial bank, Microfinance program in mosques</td>
</tr>
</tbody>
</table>

Source: interview data
4.4. Methods of data collection

This study collected both primary and secondary data. The primary data was collected during the fieldwork over the period December 2011 to December 2012 at locations in Jakarta and Yogjakarta. The developmental path of microfinance in these cities is understood to be representative of that seen in Indonesia more generally. Overall, the fieldwork activities received substantial support from case study institutions and respondents.

During the main data collection phase, the researcher was located in Indonesia for two months and had an opportunity to visit clients to observe the day-to-day operations of their microenterprises, and to attend institution-organized events and weekly meetings. The observations sought to examine the processes involved in the weekly meetings and mentoring activities and the behavior and motivation of both clients and fieldworkers. The opportunity to observe the operations of the case study institutions more closely meant that the researcher could better understand the clients’ microenterprise operating environments. Direct observations of client’s enterprises and client’s mentoring were conducted in several areas. Within Jakarta and its surrounds, the researcher visited several areas in the Ciliwung River bank and Bojong Gede West Java, located approximately 60 km from the head office of BQB to accompany the fieldworkers as they collected loan repayments. In Yogjakarta, the researcher visited several food stall microenterprises as well as attending some of the organization’s events. In addition, the researcher also attended some of BMMI’s weekly meetings in Pekalongan.

The data was collected using semi structured interviews, survey questionnaires, and direct observations. Secondary data were collected through the content analysis of government publications, institutional reports and a microfinance consultant’s publications. A description of each method follows.
4.4.1. Survey questionnaires

This research will use close-ended structured survey questions due to the possibility that some prospective respondents may have limited literacy skills. Closed-ended questionnaires may reduce the possibility of ambiguity, be more straightforward to respond to, to code and to analyze (Alpers et al., 2011). To investigate the profile of the respondents, the survey questions covered several areas including: the demographic profile of household members, means of income generation, consumption expenditure, loan and savings information, zakat and charities information, respondent’s limitations, and respondent’s participation in social assistance programs (see Appendix A).

Survey respondents included the case ICBMs’ clients and members of a non-client group. The ICBM clients had been participating in the institution’s program for less than three months. The study selected more recent clients in order to examine the clients’ initial circumstances at the time they joined the program. The non-client respondents closely matched the ICBM clients demographically and in income levels, but differed with respect to their non-involvement in an ICBM program. The non-clients are also selected as respondents in order to create a comparable group. Comparisons made between the ICBM clients and non-clients aimed to provide a basic understanding of the institutions’ preferences and priorities in client selection.

In December 2011, the questionnaire was pilot tested in Jakarta with the BQB clients to evaluate the validity, reliability and clarity of the questions before the questionnaires distributed. The initial findings from the pilot study allowed the researcher to refine the questions and to address any perceived shortcomings in relation to the type of data being sought. The pilot study generated one of the questions in the questionnaires. The researcher approached prospective participants by attending BMT Beringharjo’s and BMMI’s weekly client meetings as well as joining BQB fieldworkers when they collected loan repayments. Some of the clients wanted to participate immediately, while for others, the researcher was able to arrange a specific future meeting date. In addition, to find potential survey participants, this study extensively used client references. The
clients were willing to introduce the research study’s aims and purposes to other clients in the neighborhood such that they could consider whether to participate in the study or not.

Snowballing techniques were used to recruit the study sample. Snowballing, in a sampling context, refers to a method to find a study sample through referrals made by people who share, or know of others who demonstrate characteristics that are relevant to research interest (Biernacki and Waldorf, 1981). This sampling technique could be implemented in this study as most of the prospective respondents were clustered in a specific area, thus making them relatively straightforward to locate. Many respondents were recruited using the information of other respondents.

There are two ways of questionnaires can be distributed to respondents: self-administered questionnaires where the respondents answer and fill in the questions by themselves, and interviewer administered questionnaires, which include face to face or telephone contact between the researchers and the respondents (Alpers et al., 2011). The first method is more cost and time efficient but the response rate can be unpredictable. This study’s pilot study demonstrated that due to some participants’ literacy limitations, the questionnaires were distributed using the interviewer administered method where the researcher puts the questions directly to participants and provides assistance where required to help participants complete the question response sheets. During the interview process, the researcher was accompanied by fieldworkers who are able to communicate with the local languages. This data generation method requires sufficient time. Given a limited time of the fieldwork, only limited number of respondents can be contacted in this study. The study collected a total of 270 questionnaires from ICBM clients and non-clients in Jakarta and Yogjakarta.

4.4.2. In-depth open-ended interviews

In this study, the purpose of the in-depth open-ended interviews was to generate deeper understandings about ICBM programs and institutional sustainability from participating institutions managers’ and fieldworkers’ interview question responses. The interview
employed the general interview guide approach in which a predetermined list of questions and issues are used to open up participants’ understandings about the subjects of research interest (Patton, 2002). This guide is used to assist the researcher/interviewer to ask each question in as similar a way as possible to each interviewee (see appendix B for the interview guidance lists). Nine institutional staff members, including four fieldworkers and five senior managers were interviewed. The interviews with the fieldworkers provided information about the everyday realities of implementing the institutions’ programs; realities that may have differed from the institutional implementation guidelines expectations. Indeed, the fieldworkers’ interview responses in this study demonstrated the capacity of unstructured open-ended interviews to generate richly nuanced descriptive data.

The interview processes were conducted in two phases for each case study institution. The first phase was to understand how Islamic charity is integrated into microfinance and the second phase was to understand the sustainability potential of the institutions. In the first phase interviews, information about four issues was sought: the history of the development of the institution, its types of funding sources, the target clients, and the institutions’ products and services. In the second phase, the main questions focused on the institutions’ sustainability potential. The interview questions were designed to elicit responses related to how the institutions are responding to observed increasing competition in the industry and the strategies institutions are using to respond to these competitive pressures.

4.4.3. Document collection

In this study documents sourced from a range of reporting agencies, along with annual Indonesian microfinance institutional annual reports, were content analyzed. These documents included Indonesian banking reports from Bank Indonesia, a report on poverty provided by the Indonesian Statistics Bureau and microfinance institutional performance indicator reports provided by the Mix Market. The Mix Market is a non-profit organization that provides microfinance performance indicator data from around 2,000 microfinance institutions around the world. The study only considered reports and
other documents published between 2009 and 2012 mainly because the online data availability.

The Indonesian banking and poverty reports were used to provide the contextual background of the study that will be presented in Chapter Five. In addition, the microfinance performance indicator reports provided additional data on the performance of MFIs in Indonesia. The study collected the annual reports of fifteen Indonesian microfinance institutions consisting of rural banks, credit union/cooperatives, non-bank financial institutions, and NGOs. Indicative data specifically focused on the average loan balance per borrower was compared with questionnaire data related to establishing clients’ poverty levels.

4.5. Methods of data analysis

Of the multiple ways to construct knowledge claims in research through analysis of the data generated, deductive and inductive approaches are commonly used to analyze data in social science disciplines (Babbie, 2013). The deductive approach focuses on testing the theory and hypotheses of a specific case (Hyde, 2000). It is mainly used to analyze data from quantitative studies. By contrast, the inductive approach seeks to establish generalizations or theory from specific cases. Qualitative studies generally adopt an inductive approach by observing specific cases and then finding general understandings or theory assumed to be grounded in the data (Glaser and Strauss, 2009).

In this study, both inductive and deductive approaches were selected to analyze the research question responses. An inductive approach was implemented to analyze the data generated from institutional sustainability related questions, while a deductive approach was used to analyze responses to questions focused on institutional capability in relation to the inclusion of the poorest in microfinance programs.
4.5.1. Survey questionnaire data analysis

After collecting data from the survey, the raw survey data was tabulated and cleaned into more structured and robust data for further analysis. Three methods were used to analyze the data: descriptive analysis, poverty analysis, and the use of binomial logit regression model. The following presents an explication of how the data was prepared and analyzed.

4.5.1.1. Data preparation and choice selection of statistical methods

Initially, the raw survey data was tabulated and classified into five sample groups: the client of BMII, the clients of BQB, the clients of BMB, the non-clients in Jakarta, and the non-clients in Yogjakarta. This data then was cleaned in order to identify possible data errors, data that might be missing and data outliers. A data outlier is defined as a data point that is far outside the norm for a variable or population (Osborne and Overbay, 2008). In this study, the outliers refer to the respondents who have an annual per capita income or monthly per capita expenditure that is significantly higher/lower than the average level of income of the sample group. In this data cleaning process, such respondents are categorized as outliers and are excluded from the data set. This data cleaning process is an important step in quantitative data analysis as the presence of incorrect and inconsistent data can significantly distort the overall results derived from the data analyses (Hellerstein, 2008).

Once a final set of data was available, the data was classified into analytical variables. Based on a measurement scale, variables can generally be classified into two categories: categorical and numerical variables (Agresti, 2002). Categorical variables are the type of data that falls into a specific category, such as ‘man’ and ‘woman’, ‘level of education’ and ‘preference’. Numerical data can be divided into discrete and continuous data. Discrete data arises from the process of counting, such as counting individual people, while continuous data arises from the process of measuring, such as people’s height (Berenson et al., 2009). The variables of analysis in this study comprised both categorical and numerical data. The variables of analysis of relevant to this study are presented in Table 4.2 below.
Table 4.2. Variables of analysis

<table>
<thead>
<tr>
<th>Variable</th>
<th>Measurement scale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gender of household head</td>
<td>Categorical</td>
</tr>
<tr>
<td>Possession of saving</td>
<td>Categorical</td>
</tr>
<tr>
<td>Amount of saving</td>
<td>Categorical</td>
</tr>
<tr>
<td>Place of Saving</td>
<td>Categorical</td>
</tr>
<tr>
<td>Type of loan obtained</td>
<td>Categorical</td>
</tr>
<tr>
<td>Use of loan</td>
<td>Categorical</td>
</tr>
<tr>
<td>Source of loan</td>
<td>Categorical</td>
</tr>
<tr>
<td>Financial difficulty</td>
<td>Categorical</td>
</tr>
<tr>
<td>Serious health problem in the previous year</td>
<td>Categorical</td>
</tr>
<tr>
<td>Business skills problem</td>
<td>Categorical</td>
</tr>
<tr>
<td>Participation in a social assistance program</td>
<td>Categorical</td>
</tr>
<tr>
<td>Age of household head</td>
<td>Numerical</td>
</tr>
<tr>
<td>Education period (year)</td>
<td>Numerical</td>
</tr>
<tr>
<td>Family Size</td>
<td>Numerical</td>
</tr>
<tr>
<td>Annual per capita income</td>
<td>Numerical</td>
</tr>
<tr>
<td>Monthly per capita expenditure</td>
<td>Numerical</td>
</tr>
<tr>
<td>Amount of loan</td>
<td>Numerical</td>
</tr>
</tbody>
</table>

Source: author’s analysis

The types of data generated inform the choice of statistical model to be employed during data analysis (Agresti, 2002; King, 2008). Typically, a statistical model is developed to find relationships between dependent and independent variables. The dependent variable is the variable that needs to be tested. This variable is usually the focus of the research questions. The dependent variable may be related to, or may be influenced by a set of independent variables, or explanatory variables. Using the classification of measurement scale, King’s (2008) summary of a statistical model capable of establishing relationships between dependent and independent variables is presented in Table 4.3.
Table 4.3: the choice of statistical model based on the scale of variables

<table>
<thead>
<tr>
<th>Scale of independent variable</th>
<th>Scale of dependent variable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Categorical</td>
<td>Logistic regression or log</td>
</tr>
<tr>
<td></td>
<td>linier analysis</td>
</tr>
<tr>
<td>Continuous</td>
<td>Logistic regression or</td>
</tr>
<tr>
<td></td>
<td>discriminant analysis</td>
</tr>
<tr>
<td>Categorical/Continuous</td>
<td>Logistic regression</td>
</tr>
<tr>
<td></td>
<td>OLS regression with</td>
</tr>
<tr>
<td></td>
<td>dummy coding</td>
</tr>
</tbody>
</table>

Source: (King, 2008)

In this study, the dependent variable that needs to be tested is the participation of the respondents in the ICBM. This variable can be classified as a ‘categorical variable’ with ‘1’ representing clients who participated in the ICBM program and ‘0’ representing non-clients. As the respondents’ participation in ICBM may be influenced by several variables that include both categorical and numerical data, the use of a logistic regression model becomes an appropriate methodology to evaluate relationships between the dependent and independent variables in this study. Once the dataset was ready and the methodological approach decided upon, the next step was to analyze the data. The following sub-sections present an explication of the data analysis process.

4.5.1.2. Survey questionnaire data analysis

Respondent’s responses to the survey questionnaires will be analyzed to generate findings in relation to ICBM client outreach. The responses will be analyzed using three methods: descriptive analysis, histograms and a t-test, the use of poverty line benchmark and a binomial logit regression model’. Each method is further detailed in the following discussion.
4.5.1.2.1. Descriptive analysis, histograms and t-tests

Descriptive statistics serve as a foundation for further statistical analysis (Graziano and Raulin, 1993). In this analysis, the summary of respondents’ demographic variables, including the age of the household head, the education period, the size of family and the gender of the household head, is presented as a mean value. To evaluate whether the mean of the demographic variables of the client sample is significantly different to that of the non-clients’ sample, the study utilized a paired t-test. For a two tail t-test given a level significance of $\alpha$, the hypothesis is rejected when the computed t-test is greater than the upper-tail critical value or less than the lower tail critical value (Berenson et al., 2009).

The main proposition of the outreach inquiry, as discussed in Chapter Three is that the ICBM institutions are able to include the poorest of the poor in their microfinance programs. This proposition implies that ICBM clients may fit a more vulnerable demographic profile than that of the non-clients. This proposition suggests several hypotheses:

Ho (1): ICBM clients are older than the non-clients

Ho (2): ICBM clients have experienced a shorter period of education than non-clients

Ho (3): ICBM clients live in larger families the non-clients

Ho (4): More women are likely to be the household head in clients’ families compared to non-clients’ families

Ho (5): ICBM clients have a lower annual per capita income than non-clients

Ho (6): ICBM clients spend less on food than non-clients

Using $\alpha=5\%$, these hypotheses will be rejected if the significant value of each variable in the model estimation is less than 0.05.
In addition, for variables that are classified as categorical data, such as possession of savings, types of saving, financial difficulty, health problems, business problems and participation in social assistance programs. These variables will be presented in the form of value percentages and histograms.

4.5.1.2.2. Poverty level analysis

Poverty level analysis is used to examine the depth of ICBM institutional outreach. This study selected the food expenditure approach for determining the poverty level of a country as the use of income data as a proxy for estimating welfare dependence has many limitations. The theory of permanent income by Friedman (1957) explains that the use of income data as a poverty indicator may not be a reliable measure as income may be distinguished as being permanent or transitory. Wright (2000) also comments that income distribution information is usually distorted and highly skewed as respondents’ survey responses may provide false information if faced with income-related questions. Wright (2000) also states that an increase in income does not always result in a reduction of poverty, particularly if income is spent on discretionary items such as cinema tickets, coffee, and alcohol. Therefore, in many developing countries consumption-related information, rather than information on income alone may provide a more robust indication of welfare measures (Gunther and Klasen, 2007).

The objective of poverty level analysis in this study is to compare clients’ and non-clients’ poverty levels to the national poverty line on food expenditure developed by the Indonesian Statistics Bureau. This comparison enables the study to calculate the number of clients and non-clients who live above or below the national poverty line using the national poverty line benchmark on monthly food expenditure. A monthly per capita food expenditure variable was calculated by dividing the total monthly food expenditure of a family household by the number of family members in that household. This variable then was compared to the national poverty line on food expenditure set at Rp. 6239.8, or $0.953 in 2012 as the first benchmark. In addition, the study established a ceiling

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3 Conversion rate used for data analysis is using the purchasing power parity rate ($PPP) calculated by BPS in 2012 at 6575 rupiah.
benchmark of $2 as a benchmark figure to evaluate clients’ and non-clients’ vulnerability to a descent into poverty.

4.5.1.2.3. **Binomial logit regression model**

The third data analysis method for the survey questionnaire data is the application of binomial logit regression modeling to provide information about the probability of the respondent being selected as an ICBM client relative to not being selected. A binomial logit model is a type of logistics regression models that is used in specific cases where the dependent variable includes two categories (King, 2008). The dependent variable that needs to be examined is the participation of a prospective client in ICBM programs. The respondent can be categorized as either “being selected” or “not being selected”. Therefore, the independent variable is a type of categorical variable. In notations, \( Y=1 \) if the respondent is selected and \( Y=0 \) if the respondent is not selected.

The participation of the respondents in the ICBM program can be influenced by several explanatory variables, including \( X_1 \)= annual per capita income, \( X_2 \)=monthly per capita expenditure, \( X_3 \)=age, \( X_4 \)=size of the family, \( X_5 \)=education period, \( X_6 \)=gender of household heads, \( X_7 \)=health problem, and \( X_8 \)=business problems. The logic is that the respondent who has a more vulnerable profile has a higher probability of being selected as an ICBM client. King (2008) presents the initial logistic probability model as below:

\[
Y = p = \frac{\exp(\hat{a} + \hat{b}_1X_1 + \hat{b}_2X_2 + \cdots + \hat{b}_nX_n)}{1 + \exp(\hat{a} + \hat{b}_1X_1 + \hat{b}_2X_2 + \cdots + \hat{b}_nX_n)}
\]

\( Y \) represents the probability of a group membership. In this case \( Y \) represents the probability of a respondent is being selected as a client of ICBM given the explanatory variables. Since \( Y \) is the exponential term, the interpretation of \( Y \) is not straightforward. Therefore a transformation of \( Y \) is necessary. This can be done by multiplying both sides of equation with:

\[
1 + \exp(\hat{a} + \hat{b}_1X_1 + \hat{b}_2X_2 + \cdots + \hat{b}_nX_n)
\]
Then, the next equation can be derived as below:

\[
\frac{p}{1-p} = \exp(\alpha + \beta_1X_1 + \beta_2X_2 + \ldots + \beta_nX_n)
\]

By taking the log of both sides of this equation, the probability of a respondent being selected or not by each microfinance provider influenced by the explanatory variables can be calculated. The Statistical Package for the Social Sciences (SPSS) software will be used to carry out calculations specific to the analysis of statistical data generated by the survey questionnaire responses.

4.5.2. Analysis of the open-ended interview responses

Participants’ interview responses represent qualitative data that can be analyzed using several different methods: grounded theory, narrative analysis, discourse analysis, and phenomenology (Thomas, 2006). These methodologies are underpinned by different types of research questions depending on the purpose of the research. General inductive approaches and grounded theory characterize two qualitative methodologies that have the potential to specifically examine under-theorized phenomena (Creswell, 2012).

As discussed in the previous chapter, the theory of institutional sustainability of the ICBM has not been well developed in the literature. Thus, this study can employ either a general inductive analytical approach or grounded theory as a method to analyze data related to ICBM institutional sustainability. Given the purposes of this ICBM sustainability evaluation is not to develop a theory, but rather identify key strengths and weaknesses underpinning the achievement of institutional sustainability, a general inductive approach is an appropriate methodology to analyze the participants’ interview responses. General inductive analytical approaches allow the researcher to condense extensive and varied raw data into a more manageable format, to establish possible links between research objectives and data, and to identify possible key themes (Thomas, 2006).

To analyze the data, initial data from the participants’ in depth interview responses in the form of audio recorded transcripts are organized on the basis of interview responses to
questions related to the case ICBM's background, specific institutional characteristics and key institutional sustainability-related activities. Specifically, these activities include the generation of funding, compliance with sharia law, cost efficiency measures, the development of innovative microfinance practices, the formation of supportive community partnerships. Interview data related to rates of loan repayment was also collected in order to better understand how these rates play into the achievement of institutional sustainability.

The analysis of responses to questions related to institutional sustainability activities focuses on identifying possible strengths and weaknesses in the ways the case ICBM institutions manage these critical activities. Then, the interrelation and connection of data was identified to provide further explanation on particular issues related to the strength and weaknesses identified before. Hyde (2000) and Merriam (1988) argue that interrelationships between different data may provide a more holistic understanding of a specific phenomenon.

4.5.3. Document analysis

Document analysis is a systematic procedure to examine and interpret documents – both printed and electronic materials, in order to understand meanings and to develop empirical knowledge (Bowen, 2009). It involves the process of skimming, reading and interpretation of the contents or document themes. In the case study approach, the main aim of document analysis is to support and supplement evidence from other sources (Yin, 2009a). This study used document analysis for two purposes: as contextual background and as supportive data.

The first purpose of the document analysis in this study was to provide data on the context of the research environment. In doing so, selected data on poverty, financial exclusion and Islamic charity collection were analyzed to provide context for Chapter One’s introduction to this thesis. In addition, historical insights into the development of Islamic microfinance were identified using annual progress data reported by Islamic finance providers in Indonesia. Some of the data specifically that related to regulations, client coverage, and financial indicators were used to compare the characteristics of each
type of Islamic microfinance provider. The second purpose of the document analysis was to generate data that might supplement the survey questionnaire data such that clients’ poverty levels could be established. In the survey, the study only included two sample groups: ICBM clients and non-clients. Due to the study’s financial limitations, clients of microfinance providers other than those of the case ICBM institutions could not be included as another sample group in this study. Therefore, in order to obtain data of the characteristics of clients of other microfinance providers in Indonesia, the study collected microfinance indicators data published by the Mix Market.

To estimate the poverty level of clients of other microfinance providers, an indicator of the average loan balance per borrower was selected. The average loan balance is commonly used to approximate clients’ poverty levels (Schreiner, 2002, Rosenbeg et al., 2009, Dhakal, 2004). Smaller loan amounts generally indicate that the institution provides services to the clients at lower levels of poverty and as such, may give some indication of the extent to which the institution achieves a greater depth of outreach. The rationale here is that better off clients tend not to be interested in smaller loan/deposit accounts (Rosenberg 2009). Although this particular outreach indicator attracts significant critique on the basis of its questionable reliability to represent different levels of poverty (Ledgerwood, 1998, Rosenbeg et al., 2009), this indicator remains in common use as a proxy when primary data on clients’ level of poverty is unavailable.

This indicator of the average loan balance per borrower of each type of microfinance provider in Indonesia was compared to the survey questionnaire data in an attempt to determine the poverty level of ICBMs clients. In this case, the study utilized two types of data in order to establish the capability of the case study ICBM institutions to include the poorest in their microfinance programs.

4.6. The scope of the study

Due to limited resources available for this study, the scope of the study is restricted to several matters identified bellow. First, data collection was only done in two cities in Java Island. As such, to explain the findings, the study only considered values and beliefs of
the Javanese. Since Indonesia consists of many different culture; this study's findings may only be applicable in Java and may not be applicable for other parts of Indonesia, such as in western and in eastern parts.

Secondly, the study only include clients and management of ICBM institutions as research participants and do not include other stakeholders. Consequently, the study findings related to the achievement of ICBM institutional sustainability may disregard the perspectives of the donors. It is suggested that similar study in this topic should include donors as research participants since donor's participation in the program also determines the ICBM sustainability. Lastly, the study only included secondary data from the period 2009-2012, mainly because the unavailability of online reports before the 2009.

4.7. Conclusion

This chapter presented the study's research methodology selected to examine the institutional sustainability and the ability of the ICBM institution to include the poor in the program. The chapter illuminated the study's data collection methods and set out a rationale for how the data was analyzed. Data collection methods included survey questionnaires, interviews, document analysis of government publications and institutional reports, and observation.

The survey questionnaire data were used to respond to the question of the capability of the case ICBMs to include the poorest in their microfinance programs. These data were analyzed using a statistical methodology including descriptive statistics, paired t-tests and a binomial logit model. Interview data were mainly used to respond to the research questions on institutional sustainability. These interview data were analyzed using a general inductive approach to identify the strengths and weaknesses of the ICBMs in achieving institutional sustainability. Government publications and institutional reports were analyzed by document analysis methods and the data generated were used mainly to provide background and context to the study. Lastly, observational data served as
additional data to strengthen the overall data analysis. The next chapter will provide the contextual background of this study by explicating the development of Islamic microfinance and ICBM in Indonesia.
Chapter 5

Islamic microfinance and Islamic charity based microfinance in Indonesia

5.1. Introduction

Indonesia is home to a large number of highly diverse microfinance institutions and various microfinance programs (Ravicz, 1999). The Indonesian microfinance sector includes large financial self-sufficient micro-banking systems and many smaller microfinance institutions that differ from each other in terms of scale, variety, volume, market segmentation and profitability (Robinson, 2001). Bank Rakyat Indonesia (BRI) is an example of a large scale commercial microfinance institution that offers a full banking service covering all provinces in Indonesia (see Patten et al., 2003, Klause, 2004). Other examples of smaller microfinance institutions include Islamic financial institutions (BMTs) and village microfinance institutions that have smaller asset bases, offer limited financial services and have limited service coverage. Both BMTs and village microfinance institutions are well-known for their capacity to successfully reach grassroots sections of the population and are capable of integrating cultural considerations into their programs (Sakai, 2008, Antonio, 2008).

The focus of this chapter’s discussion is Islamic charity based microfinance (ICBM) in Indonesia. The discussion is constructed on insights gleaned from the existing literature and from the data generated from the study’s fieldwork. This chapter underpins the thesis’ main argument that microfinance has a greater chance of being sustainable and more inclusive of the poorest members of society if Islamic charity is used as a significant source of funding, through the chapter’s explication of the practice of ICBM within the Islamic microfinance industry. This explication will highlight the role played by ICBM to increase the participation of the poor in microfinance. The chapter begins with a discussion on the early development of microfinance and Islamic microfinance in Section 5.2, within which various microfinance models in Indonesia are examined. Section 5.3 takes up a discussion on the current development of Indonesian Islamic
microfinance in relation to the types and characteristics of providers, and its diverse
target markets. From an account of key actors within ICBM in Section 5.4, the chapter
then introduces the selected case study ICBMs institutions. Section 5.6 concludes the
chapter.

5.2. The history and development of Islamic microfinance in Indonesia

The history of microfinance in Indonesia can be traced back to the 19th century during
the period of the Dutch colonial era. History shows that microfinance has played an
important role in economic development by channeling government funding into
agricultural sector and increasing access to financial services. The development of
Islamic microfinance to current times evolved over three major phases: First, between
the 1890s and the 1980s, a period that saw the development of conventional
microfinance systems in Indonesia, second, the emergence of the concept of Islamic
microfinance between the 1980s and the 1990s, and thirdly, the period of Islamic
microfinance development between 1990-2000. The following discussion focuses on
major achievements over the course of these three phases of Islamic microfinance
development and analyzes the success factors of a variety of Indonesian microfinance
providers.

5.2.1. The period of 1890s-1980s

The pioneers of microfinance institutions in Indonesia – village banks and paddy banks
(lumbung desa) were developed in the 1890s in Java and Madura by Dutch colonial
(Rosengard et al., 2007). These institutions relied entirely on the mobilization of local
resources and self-financing to provide credit to and set an annual loan interest rate of
15%-45% (ADB, 2009). These pioneering institutions showed impressive performances
during the Great Depression, but went into decline during the Japanese occupation of
1940s, a time of much violence, administrative dislocation and economic chaos (Henley,
2010).

Parallel to the development of village banking institutions described above, Bank Rakyat
Indonesia (BRI) was established in 1895 in Purwokerto, Central Java, by Raden Aria
Wiraatmaja (Bank Rakyat Indonesia, 2011). Using his own money, this institution initially provided credit for the *priyayi*. This credit provision was expanded and extended to civil servants and farmers using Islamic charity collected from the local mosques (ADB, 2009). Although this ‘self-funding’ practice attracted much public criticism due to allegations of the misuse of mosque funds, this former BRI institution continued to expand its services. This particular development provided evidence that the utilization of Islamic charity within microfinance practice had its early beginnings early in 19th century.

After Independence in 1945, the development of the agricultural sector to increase food production was high on the Indonesian government’s agenda. The Bimbingan Masal (BIMAS) program that was initiated in 1964, was a significant agricultural development program designed to provide both loan funds and training for farmers in farm management techniques. The training programs were particularly focused on intensifying rice production (Kuiper, 2003). To channel the subsidized government credit scheme to farmers, the Village Unit of BRI was developed in 1968 as a government agency (Rosengard et al., 2007). Three thousand six hundred new branches of the BRI were established in Java, Bali and surrounding islands. Unfortunately, this program was not sustainable and was suspended in 1984. Rather than dismantling the existing infrastructure and ceasing existing BRI branches’ operations, BRI was transformed from a state subsidized agricultural credit institution into a profitable microfinance institution that operated independently from its funding donors (Robinson, 2001).

The transformation of BRI led to rapid success in the two years following its original conception. BRI has been able to provide services to a large number of clients while achieving financial sustainability and has become a leader in the provision of commercial microfinance in Indonesia through its country-wide network of 7975 branches (Chaves and Gonzales-Vega, 1996, Rosengard et al., 2007, Robinson, 2005). BRI now serves over 36 million people and has a net income of 15.09 trillion rupiah in net income (Bank Rakyat Indonesia, 2011).

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4 The respectable group of society
Many other smaller microfinance providers also performed well in their sustainability and outreach, as exemplified by village credit institutions, Badan Kredit Desa (BKD), operated by local governments in 4000 villages across Java and Lembaga Perkreditan Desa (LPD) in Bali. These two institutions share similar characteristics in their delivery of microfinance services and programs in that they are owned by the state, apply commercial transactions and provide individual lending, rather than group lending (Henley, 2010). As distinct from other developing countries, the Indonesian microfinance industry is dominated highly successful government-owned microfinance providers such as BRI, BKD, and LPD in which the public has placed a high level of trust (Patten et al., 2003). With the collapse of private banks during the 1998 economic downturn, people felt safer depositing their money in state-owned financial institutions that guaranteed the security of banks’ deposits and loans.

In spite of their public ownership, government-owned institutions also ran their microfinance operations on a commercial basis, without depending on donors’ subsidy. This operational approach allowed them to achieve profitability and to expand their outreach services. Interestingly, BKD, LPD and BRI were consistent in their individual, rather than group, lending policies. As loans provided to clients sometimes required some form of asset guarantee, or loan collateral; clients without were seen to be discriminated against. As such, many poor and needy prospective clients were financially marginalized. Currently, half of Indonesian households have been served by various MFIs (Henley, 2010). That over half of Indonesia’s households have received financial support from MFIs testifies to the significance of these microfinance institutions to improving the financial circumstances of Indonesia’s needy.

5.2.2. The period of 1980s-1990s

The history of Islamic microfinance providers in Indonesia was first recorded in the early 1980s (Antonio, 2000), well after the establishment of their non-Islamic microfinance counterparts. Although Islam constitutes the majority religion in Indonesia, the expression of faith through secular activity was very limited before this
period. Two opinions explained why Islamic finance has only been adopted lately. The first argument convinced that failure of the capitalist economy in reducing poverty and inequality was the main reason of the development of Islamic finance. Islamic finance was seen as an alternative system that has more capability to address such problems (Syahbudi, 2003). The second argument believed that the adoptions of Islamic finance is necessary to enhance financial inclusions since many Muslims do not want to participate in the financial system due to religious constraints (Karim et al., 2008).

In Indonesia, Lindsey (2012) noted that the development of Islamic financial products formed part of efforts made by the new order regime lead by President Soeharto to gain support for his authority from Muslim organizations. Further, Kasri and Kassim (2009) reported at that time that the development of an Islamic finance system was initiated by Muslim scholars and academics during the 1990 Majelis Ulama Indonesia (MUI – Indonesia Jurist Council) conference in Cisarua Bogor. From this meeting, a task force was formed to further develop the idea of Islamic banking in Indonesia (Antonio, 2000). This idea could not be directly realized since banking regulations at that time were unable to accommodate the idea of Islamic banking (Banking Law 14/1968). The major responsibility of the task group then fell to better understanding how related financial considerations could be implemented within an Islamic banking system (Antonio, 2000).

Although formal regulatory support did not exist at the time, two microfinance institutions had been established during this period: Baitul tamwil in Bandung West Java, established in the 1980s (Wahyuni, 2007), and in the same year, the Ridho Gusti cooperative was established in Jakarta. Yet, very little has been documented about these institutions.

5.2.3. The period of 1990s-2000s

This was the important period in the development of Islamic finance system in Indonesia. Several major achievements in this period included the establishment of Bank Muamalat Indonesia as the first Islamic bank in Indonesia, the enactment of the regulation on dual banking systems, and the growing of Islamic financial cooperatives.
During this period, Islamic finance started to gain public awareness through its greater participation in the broader financial services sector. Its development was officially endorsed and supported by the government and civil society (Holloh, 2001, Antonio, 2000, Lindsey, 2012).

The establishment of Bank Muamalat Indonesia (BMI) was a major breakthrough for the Islamic banking system in Indonesia. Although without any regulated support, BMI was established in November 1991 by Islamic scholars and Muslim organizations as the first Islamic bank in Indonesia. One year after the birth of BMI, the first regulation on Islamic banking practice that recognized bank profit sharing practices was realized under Banking Law 7/1992. This law did not fully embrace the concept of an Islamic banking system. Bank Mualamat was the only Islamic commercial bank in Indonesia up until the 1998 Asian Financial Crisis (AFC). The AFC caused an economic downturn that led to the collapse and eventual demise of many conventional banks. Islamic banks came through the AFC relatively unscathed and recovered more quickly than the conventional banks as the Islamic banks did not have to pay the market rate of return to their depositors (Lindsey, 2012, Kasri and Kassim, 2009). That the outcomes of the AFC for the Islamic banking sector were favorable, suggested to the public that Islamic banking institutions were more reliable than conventional banks in times of economic weaknesses and uncertainties.

The years between the 1990s and 2000s was significant for the Islamic banking system in that it gained official acknowledgement and full support from Bank Indonesia through the realization of Indonesian Banking Law 8/1998. As distinct from the former Banking Law 7/1992, this later law clearly acknowledged the existence of a dual banking system in Indonesia: a conventional system and an Islamic system, both operating under the supervision of Bank Indonesia.

The positive response from the public to the idea of Islamic banking was reflected in the development of several Islamic microfinance institutions during the early 1990s. The first four Islamic rural banks were initially set up in the second half of 1991. Three were located in the Bandung area with one located in Aceh (Seibel, 2008). These locations
were likely chosen in response to the existing demand for sharia compliant financial products in these areas.

In addition to the establishment of the Islamic banking system, the first formal Islamic financial cooperative, *Baitul maal wat tamwil* (BMT) Bina Insan Kamil also opened in 1992. The original motivation for developing the BMT lay in Bank Mualamat’s reluctance to provide financial services for low income micro-entrepreneurs (Antonio, 2008). With religious commitment as an additional motivation, some Muslim scholars designed an appropriate model for a financial system dedicated to poverty alleviation in Indonesia (Sakai, 2008).

The development of BMT towards its mission to alleviate poverty received strong support from government and private sectors. In the initial stages of BMT's development, the private Islamic charity institution, Dompet Dhuafa extended support through its offer to provide training for Muslim entrepreneurs to encourage the development of BMT. The first training program was conducted in September 1994. This program successfully motivated the establishment of BMTs in many areas of Indonesia including BMT Beringharjo in Yogyakarta and BMT An Najah in Pekalongan (BMMI-2, 2011).

The development of BMT towards poverty alleviation strategies also gained robust support from the state when former president Soeharto launched the BMT as part of the national movement for economic development during a meeting of Islamic scholars in Jakarta on 7th December 1995 (Noor, 2000). BMT was mandated to empower society through institution building and small business development (Holloh, 2001). In the same year, a Memorandum of Understanding between Bank Indonesia and YINBUK was signed in which BMT was given the opportunity to participate in linkage programs and self-help group program with the commercial banks (Holloh, 2001). From its first establishment in early 1990s up until 1998, the number of BMT cooperatives increased significantly. From 2000, growth began to stagnate with continual decline evident through to 2003. The blame for BMTs negative growth was assumed to lay in the lack of
government regulation and supervision over this period (Sakai, 2008, Sakai and Marijan, 2008, Seibel, 2008).

Table 5.1. The growth of Islamic financial cooperatives

<table>
<thead>
<tr>
<th>No</th>
<th>Phase</th>
<th>Period</th>
<th>Number of BMTs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Initial growth</td>
<td>1990-1995</td>
<td>300</td>
</tr>
<tr>
<td>2</td>
<td>Rapid growth</td>
<td>1996</td>
<td>700</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1997</td>
<td>1501</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1998</td>
<td>2470</td>
</tr>
<tr>
<td>3</td>
<td>Stagnation</td>
<td>2000</td>
<td>2938</td>
</tr>
<tr>
<td>4</td>
<td>Stagnation and decline</td>
<td>2001</td>
<td>3037</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2003</td>
<td>2856</td>
</tr>
</tbody>
</table>

Source: Adapted from Seibel (2008)

History indicates that various microfinance models have existed and played significant roles in the provision of small scale financial services in Indonesian society. In this country, microfinance was successfully delivered using both small and local institutions, such as village banks, as well as large scale commercially institutions, such as the established commercial banks.

The previous discussion in this section attempted to give some sense of the gathering momentum in the development of Islamic microfinance in Indonesia. Up until the early 2000s, Islamic microfinance providers included commercial Islamic banks, Islamic rural banks and Islamic financial cooperatives (BMT). Over the period discussed, the adoption and practical application of Islamic finance principles to the microfinance sector has gained significant ground. The major concern now is how this sector can both sustain its growth and contribute to the economic development of Indonesia. The following discussion focuses on current developments in Islamic microfinance. In this, attention is given to the rise of ICBM emergent from a growing Islamic charity sector in Indonesia.
5.3. The current development of Islamic microfinance in Indonesia

Current Islamic microfinance operations in Indonesia are still dominated by Islamic commercial and rural banks that come under the umbrella of formal and regulated microfinance institutions. In contrast, financial cooperatives such as BMT’s risk viability in the current complex regulatory and supervisory environment. Early in 2013, under the Microfinance Institution law 1/2013, a new law governing the operation of BMT came into effect. This law brings new hope to the further development of Islamic microfinance in Indonesia. This section reviews the current development of Islamic microfinance in Indonesia by examining the characteristics of microfinance providers, existing microfinance regulations and the rise of the integration of Islamic charity into microfinance.

5.3.1. The providers and the regulations

Similar to its conventional counterparts, Islamic microfinance in Indonesia also comprises various types of providers. Islamic microfinance providers are regulated by two major bodies: state regulators, including Bank Indonesia and Financial Services Authority (FSA), and Dewan Syariah Nasional Majelis Ulama Indonesia (DSN MUI) as the evaluator of sharia compliance within the Islamic financial products and services sector.

On their legal status, microfinance institutions in Indonesia can be classified into banking-type microfinance institutions and non-banking-type microfinance institutions. The banking-type microfinance sector is subject to commercial banking laws (Undang Undang Perbankan 10/1998) under an amendment to Banking Law 7/1992. The Banking Law 10/1998 officially supports a dual banking system. The implication is that both conventional and Islamic banks are supervised by Bank Indonesia. In addition, the practical implementation of Islamic banking practices is clearly governed by Syariah Banking Law 21/ 2008 (UU Perbankan Syariah 21/2008). This law provides guidance in relation to the daily operations of Islamic banking practice.
The nonbanking microfinance sector is regulated under the Microfinance Institutions Law 1/2013. Two types of institutions are subject to this law: financial cooperatives and limited financial enterprises that are majority owned by local governments. Both institutions can offer Islamic financial products. The major differences between these banking types and non-banking types of microfinance institutions lie in their institutional scale and coverage. The non-banking-type microfinance institutions conduct small scale transactions within a small area of the local district coverage. Once coverage extends beyond one district level, the non-banking-type microfinance institution has to be converted into a rural bank. In addition, the law also stipulates that non-banking-type microfinance operations are not intended to be solely profit driven. The non-banking-type microfinance institutions are supervised and monitored by the Indonesian Financial Services Authority (FSA).

The government owned pawnshop Perum Pegadaian represents another type of non-banking microfinance. Perum Pegadaian provides microfinance using both conventional credit schemes and a sharia mechanism. This institution is regulated by Government Regulation 103/2000 that mandates the provision of financing on a micro scale in order to reduce the involvement of informal moneylenders.

Before the implementation of the Microfinance Law 1/2013, Islamic financial cooperatives were categorized as semiformal microfinance institutions subject to complex and unstructured regulations from several Indonesian authorities. These regulations include the regulation of the establishment of BMTs as published in the Ministry of Home Affairs circular, the regulation of BMT membership as contained in the commercial trade law, the regulation of initial capital funds and savings within cooperative law proceedings and the regulation of the functions of *baitul maal* in *zakat* management law (Juwaini et al., 2010). The complexity of this regulatory environment can lead to difficulties in institutional supervision and monitoring and, as documented by Sakai and Marijan (2008), may portend major failures within Islamic financial cooperatives. The new microfinance law encourages professionalism and transparency within microfinance institutions by requiring them to provide periodic reports to the FSA as the key supervisory body. The law also brings together existing regulations.
within the microfinance sector. However, there are still unsolved issues, particularly in relation to the use of Islamic charity within microfinance practice.

In Indonesia, the collection and distribution of *zakat*, as a compulsory Islamic levy, is regulated under *zakat* law UU Pengelolaan Zakat 23/2011. Article 27 notes that *zakat* can be distributed for productive activities aimed at encouraging recipients to generate income through entrepreneurship. Unfortunately, since the implementation of the *zakat* law, specific government regulations on productive *zakat* practice have not been realized. In other words, the regulation of ICBM remains unclear.

From the foregoing, it can be seen that the formal and commercial microfinance sectors have received sufficient support from existing microfinance regulations, including from three significant regulations pertaining to microfinance practice in Indonesia: the Syariah Banking Law (UU Perbankan Syariah 21/2008), the Microfinance Institutions Law (UU Lembaga Keuangan Mikro 1/2013), and *zakat* law (UU Pengelolaan Zakat 23/2011). Special attention to the development of regulations relevant to the use of Islamic charity into microfinance is still needed. The increasing popularity of Islamic charitable as a microfinance funding source requires sound implementation guidelines to underpin efficient and effective use of this charity.

From a sharia compliance perspective, the use of *zakat* in microfinance programs is permissible by the Islamic jurist in Indonesia (Majelis Ulama Indonesia). The first fatwa on productive *zakat* was issued in 1982. This fatwa allows *zakat* to be distributed for productive activities for the poor and for improving the wellbeing of society. The more detailed fatwa on *zakat* and investment (Fatwa no 14 2003) acknowledges that *zakat* can be distributed for micro and revolving loans. The funds are distributed with the aim of meeting specific requirements such as alleviating poverty conditions and providing the poor with basic provisions. It is argued that in an Indonesian context, these requirements are hard to meet due to the nation-wide prevalence poverty cases. Table

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[Islamic religious decree issued by Islamic jurists]
5.2 sets out the details of a number of Indonesian Islamic microfinance actors and regulations.

Table 5.2 Islamic microfinance actors and its regulations

<table>
<thead>
<tr>
<th>Actors</th>
<th>Banking type microfinance</th>
<th>Non Banking type microfinance</th>
<th>Program microfinance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Regulations</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Commercial Banking Law</td>
<td>- Microfinance Institution Law</td>
<td>- Zakat law (Undang- Undang Perbankan 10/1998)</td>
<td></td>
</tr>
<tr>
<td>- Sharia Banking Law (UU Perbankan Syariah 21/2008)</td>
<td>- Pawnshop Government Regulation 103/2000</td>
<td>- Zakat-funded microfinance: has not been regulated</td>
<td></td>
</tr>
<tr>
<td><strong>Institutions</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Islamic commercial banks and Islamic rural banks (BPRS)</td>
<td>- Islamic Financial Cooperative and Limited financial enterprise that majority owned by local government</td>
<td>- Islamic charity institution</td>
<td></td>
</tr>
<tr>
<td>- Sharia Banking Law (UU Perbankan Syariah 21/2008)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Supervisory body</strong></td>
<td>Central Bank of Indonesia</td>
<td>Financial Service Authority (FSA)</td>
<td>Badan Amil Zakat Nasional (BAZNAS)</td>
</tr>
</tbody>
</table>

Source: Author’s own work

5.3.2. The characteristics of the Islamic microfinance providers

Various Islamic microfinance providers exhibit different characteristics in their products and services, target clients and outreach overage. This section presents the characteristics of four different types of Islamic microfinance providers: Islamic commercial banks, Islamic rural banks, Islamic financial cooperatives, and program microfinance.
5.3.2.1. Islamic commercial banks

There are two types of Islamic banks in Indonesia: fully fledged Islamic banks and sharia units of conventional banks. The sharia unit of conventional banks (Unit Usaha Sharia/UUS) represents the division of conventional banks that operate under sharia principles. Currently, Islamic commercial banks are the major actors in the Islamic microfinance industry comprising 11 fully fledged Islamic banks, 24 shariah units within conventional banks, with 1737 shariah branches and 1277 shariah services units providing financial services to over 1.5 million clients (Bank Indonesia, 2011a).

Although Islamic banks’ total assets represent only 5% of those held by conventional banks, the years 2010-2012 have seen significant growth in the asset base of Islamic banks, with growth reaching 33.5%, 47.5% and 49.2% respectively (Bank Indonesia, 2008, 2009, 2010, and 2011). Compared to the fluctuating growth pattern experienced by conventional banks, these growth figures are remarkable. The main driver of this growth is claimed to be the increasing tendency of middle class Muslims to internalize Islamic principles. Islamic banks have successfully penetrated this segment by locating its operations in the urban areas of major capital cities where this sector of the Muslim population choose to live. Currently, 50% of the Islamic bank market is located in Jakarta. The increasing public demand for sharia compliant finance products, in concert with the flow of funds from oil exporting countries, is estimated to have reached $2.25 million in 2007 and is said to be one of the key contributing factors to the rapid growth of the Islamic microfinance sector (Lindsey, 2012).

Islamic commercial banks offer a similar range of financial services to those offered by conventional banks, including savings products, financing and fee-based transactions. The average financing amount per client is the highest of all other types of Islamic microfinance providers, averaging approximately $11,970 (78.7 million rupiah) per client. Islamic commercial banks can be categorized as microfinance institutions as more than 61.29% of their clients are categorized as small and medium enterprises (Bank Indonesia, 2007). The commercial Islamic bank characteristics illuminated above suggest that the banks’ target market lies within the middle class population.
5.3.2.2. Islamic rural banks

Islamic rural banks are another type of formal Islamic microfinance institution. The major differences between Islamic rural banks and Islamic commercial banks are firstly, that the rural bank conducts its operations in provincial regions through its offering of limited types of financial products and second, targets a different market segment (Bank Indonesia 2012). Rural banks only offer savings and loan products to targeted micro, small and medium enterprises and cannot conduct transfers and clearing processes.

Rural banks have the greatest outreach in Indonesia’s microfinance industry. By the end of 2011, there were 1,669 rural bank units, with 1,223 branches and 1,280 sub-branches. Although Islamic rural banks were established only two years after conventional rural banks, their rate of development lagged far behind their counterparts. In 2011, there were only 155 Islamic rural banks, compared to 1,669 conventional rural banks (See Table 5.3).

The slow growth of Islamic rural banks indicates a possible lack of popularity of sharia compliant products in rural areas of Indonesia. This finding may also confirm the observation that the demand for Islamic finance products is predominantly located in urban areas; an observation that may have implications for the types of clients ICBM is best placed to target. Using a study carried out in Central and East Java, Seibel (2008) documented that only 11% of the population in this region understood these Islamic finance products. Interestingly, El Zoghbi and Tarazi’s (2012) study argued that decisions prospective clients make in relation to Islamic banking products and services are shaped less by religious issues and more by the proximity and accessibility of the banking institution’s services.
Table 5.3. Growth in the number of conventional rural banks and Islamic rural banks

<table>
<thead>
<tr>
<th>Year</th>
<th>Rural Bank</th>
<th>Islamic Rural Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>1772</td>
<td>131</td>
</tr>
<tr>
<td>2009</td>
<td>1733</td>
<td>138</td>
</tr>
<tr>
<td>2010</td>
<td>1706</td>
<td>150</td>
</tr>
<tr>
<td>2011</td>
<td>1669</td>
<td>155</td>
</tr>
</tbody>
</table>

Source: Bank Indonesia

Similar to Islamic banks, 70% of Islamic rural banks’ financing is distributed to micro and small enterprises (2009). The average amount of funding distributed per client is $2,098 or about 13.8 million rupiah; an amount lower than that distributed by Islamic commercial banks, suggesting that Islamic rural banks offer lower levels of financing to lower income earners than that of the Islamic commercial banks.

5.3.2.3. Islamic financial cooperatives

The concept of an Islamic financial cooperative is known in Indonesia as *Baitul maal wat tamwil* (BMT), or Koperasi Jasa Keuangan Syariah (KJKS). As earlier discussed in the chapter, this type of Islamic microfinance institution is one of the oldest in Indonesia. *Baitul maal wat tamwil* in Indonesia includes two institutions: *Baitul maal* (House of Treasury) and *Baitul tamwil* (House of Trade). *Baitul tamwil* is the commercial unit developed on a similar conceptual basis as the financial cooperative. The initial capital is collected from members of the cooperative and through the mobilization of savings deposits. *Baitul tamwil* offers both micro saving and micro lending products and services that are established on Islamic principles and that are targeted to low-income entrepreneurs. The second institution, *Baitul maal*, is the social unit that collects Islamic charity from BMT members and distributes these charitable funds for social purposes. The services offered by *Baitul maal* include economic empowerment programs and direct distribution of charity. The Islamic financial cooperative is one of the best examples of community-based microfinance. Sakai (2008) argues that BMTs have the potential to empower the community by offering adequate funds and workable schemes that may go some way to ameliorate poverty conditions. BMTs are legally formed as financial cooperatives under the supervision of the Financial Services Authority (FSA). Financial
cooperatives mostly serve rural areas and target lower income population sectors by offering loan amounts that are approximately 10% of those offered by Islamic rural banks.

Before the enactment of microfinance law in 2013, many BMTs were registered under the Ministry of Cooperatives. Some BMTs were also registered as members of financial cooperative associations. There are three BMT associations that work with the government to support the development of these institutions: BMT Centre (100 member BMTs), PINBUK (3000 members of whom 2000 are active), and Microfin (700 member BMTs) (Wahyuni, 2007). The BMT’s associations provide financial assistance, training and development support. To be eligible for this support, members have to provide financial statements to the associations. The number of unregistered BMTs is estimated by Bank Indonesia to be around 81% (Seibel, 2008). Bank Indonesia has encouraged well performing BMTs to convert to the Islamic rural banking system in order for these institutions to be better supervised and monitored (Juwaini et al., 2010). Although in one sense, this conversion is beneficial to create a more effective supervision, the outcome may be that BMTs will exit their current market segment and operate in a more commercial-like manner similar to other mainstream microfinance institutions.

5.3.2.4. Islamic charity based microfinance program

ICBM programs offer non-interest financing for the poor and needy to be used as startup capital for micro-enterprises. This type of microfinance program draws on Islamic charity as their main funding source. The programs are implemented at the subdistrict level around Jakarta and Java, and are rarely found in other parts of Indonesia. The average amount of financing per client is very low, about $102 (0.67 million rupiah)⁶. This low average amount of financing per client indicates that these institutions target the poor at the lowest level of poverty compared to ‘per client’ amounts lent by the other three microfinance institutions. Table 5.4 presents a comparison of the funding amounts loaned by a range of microfinance providers.

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⁶ Derived from the data collected during field study in three institutions presented in the chapter 6 and 7
Table 5.4 suggests that the four types of Islamic microfinance in Indonesia offer different types of services to different target markets. Using the average loan balance as a poverty level indicator (Schreiner, 2002), it can be seen that the average loan balance of Islamic commercial banks is the highest compared to other institutions, suggesting that these institutions serve non-poor clients, while Islamic cooperatives and ICBMs penetrate lower income level communities.

Similar to conventional banks, banking-type Islamic microfinance institutions also show a reluctance to serve the poor. Nugroho (2010) argues that this reluctance may be due to the commercial banks’ limited capability to both address informational asymmetry and to enforce equitable policies related to lending to the poor. Further, the costs of providing financial services to the poor may deter profit seeking banks from reaching out to this financially disadvantaged group. Findings from a study by Bank Indonesia and GTZ (2000) accord with Nugroho’s argument that the majority of Indonesia’s poor are not well-served, if at all, by the commercial microfinance sector. Interestingly, the Bank Indonesia study also found that the poor already actively participate in non-formal microfinance through informal money lenders and credit rotation schemes (Bank Indonesia and GTZ, 2000).

Informal microfinance institutions, in many forms, are widespread throughout Indonesia. Morduch (2007) asserted that 25% of Indonesian population living below the poverty line actively participated in informal financial services in Indonesia. The sources of informal financial services include joint venture, a self-managed institution, professional moneylender, family/relative/friends, or other informal source. Arisan and informal money lenders constitute well-known examples of non-formal microfinance schemes. The arisan scheme conducts monthly meetings to collect money from each of its member participants. These monies are then allocated to members according to their position on a roster. Many Indonesians join arisan for social and financial purposes (Martowijoyo, 2007). Some arisan schemes also provide members loans that are for the most part interest-free (Candland, 2011). In addition, informal money lenders, known as renternir, also operate as lending agents within Indonesia’s poor communities. Loans provided by informal money lenders attract high interest rates that would most likely exclude the poor’s participation in these informal lending schemes. Nonetheless, these
informal microfinance services, located close to prospective borrowers’ communities, are readily available to the local population’s poorest, offer minimal transaction costs and suggest that lenders have a sound understanding of borrowers’ financial status and borrowing needs (Miyashita, 2000). These informal services provide financial access mainly to the poor and the very poor to enable these clients to more effectively manage their daily financial difficulties. This wide participation of the poor in non-formal microfinance services indicates that the poor, neglected by formal financial institutions, also require alternative basic financial products to improve their financial standing. At the same time, the study findings point out the significant potential of ICBM to penetrate this financially disenfranchised market through their expansion of inclusionary practices.

Table 5.4 A comparison of selected characteristics of Indonesian Islamic microfinance providers

<table>
<thead>
<tr>
<th>Financial Products</th>
<th>Islamic Banks</th>
<th>Islamic Rural Banks</th>
<th>Islamic Financial Cooperative</th>
<th>ICBM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Products</td>
<td>- Cheque</td>
<td>- Saving</td>
<td>- Saving</td>
<td>- Voluntary saving</td>
</tr>
<tr>
<td></td>
<td>- Saving</td>
<td>- Financing</td>
<td>- Team deposit</td>
<td>- Interest free financing</td>
</tr>
<tr>
<td></td>
<td>- Team deposit</td>
<td></td>
<td>- Financing</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Financing</td>
<td></td>
<td>-</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Feebased transactions</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Locations</th>
<th>Mostly in urban area, 50% in Jakarta</th>
<th>Provincial region</th>
<th>Provincial and district (Kabupaten) region</th>
<th>Provincial and district region</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financing Mechanisms</td>
<td>- Profit-loss sharing</td>
<td>- Profit-loss sharing</td>
<td>- Profit-loss sharing</td>
<td>- Interest free financing</td>
</tr>
<tr>
<td></td>
<td>- Sale contract</td>
<td></td>
<td>- Interest free financing</td>
<td></td>
</tr>
</tbody>
</table>

- 117 - | Page
Average financing per client ($)

<table>
<thead>
<tr>
<th></th>
<th>11,970</th>
<th>2,096</th>
<th>184</th>
<th>102</th>
</tr>
</thead>
</table>

Source: Author's own work

5.4. The Islamic charity based microfinance in Indonesia

ICBM is defined as the integration of Islamic charity into microfinance practice. This integration can be implemented either through the use of Islamic charity as the source microfinance program funding, or by integrating two institutions: one an Islamic charity institution and the other a microfinance institution. The first integration model is exemplified by the funding arrangements zakat organizations' make in the development and implementation of their empowerment programs. The second model, the integration of two institutions, is well represented by BMT. The following discusses these two existing models of ICBM integration in Indonesia.

5.4.1. The actors within ICBM sector

5.4.1.1. Zakat institutions

The engagement of zakat organizations in the microfinance sector represents efforts by microfinance organizations to find robust mechanisms to distribute charity in ways that can attract donor participation as well as increase the impact of charity in society. Although the practice of Islamic charity has been in existence since the arrival of Islam in Indonesia (Amelia, 2008), the modern zakat institution is a relatively new phenomenon. Traditionally, Islamic charity is distributed directly from wealthy Muslims to prospective recipients (Ariff, 1991). Islamic charity is distinctive for its funding of the poor’s personal consumption needs. Over the past decade, the dramatic increase in the distribution of zakat funds directly to the poor through highly public distribution mechanisms, has provided very wealthy donors’ a stage on which to openly display their social financial status (Abdullah, 1991). Donors determine the conditions (e.g., day and
time) under which zakat funds will be distributed. At the time of distribution, the close gathering of large numbers of the poor, including the elderly and children, can lead to chaotic situations as people compete with each other for a share of the limited amount of zakat available. Traditional zakat is rarely distributed for community purposes; thus any benefits are more temporary than permanent.

In addition to direct personal distribution, zakat is commonly given to mosques or social and religious organizations. These organizations usually invite people whose names are registered in the telephone book to pay zakat to organizations that may be in the process of establishing and/or renovating their public facilities (Abdullah, 1991). This practice of inviting donors has recently decreased as the institutions’ credibility has come into question by the public due to unobserved outcomes of the given charity.

Up until the 1960s, state intervention into the collection and distribution of zakat was very limited (Amelia, 2012). Due to political instability at the time, the old regime government (1945-1965) paid little attention to religious matters. The first Ministry of Religious Affairs began to manage zakat in 1952. The Ministry’s 1954 report into zakat revealed that the collection and distribution of zakat funding took place in eight major provinces: Jakarta, West Java, East Java, Central Java, Yogjakarta, South Sumatra, Kalimantan and Sulawesi. The report also revealed that zakat funding collected in Islamic boarding schools, mosques and religious groups was massive. Unfortunately, there were no policies related to zakat management at that time that could control zakat funding practices.

Zakat development gained momentum in Indonesia during 1968 when eleven Islamic scholars asked the president to advise the Muslim society of the importance of paying zakat. Specifically, they asked the President to suggest that the local government should actively manage the collection and distribution of zakat. The scholars noted that the obligation of paying zakat would not only benefit Muslim society but also society as a whole (Abdullah, 1991). In response to this request, President Soeharto appointed himself as the national amil (zakat collector). Along with this initiative, he selected three of his staff to help him collect and manage zakat. The President’s views on the importance of zakat as a strategy to address poverty were announced through his Islamic
celebration days speeches from 1968 to 1974 and in his autobiography published in 1968.

The first formal zakat institution to be established was Badan Amil Zakat (BAZIS) Jakarta (Amelia, 2012). This organization was developed in response to the recommendation of President Suharto at that time that the management of the collection and distribution of zakat funds should reside both at the national level and at established sub-district levels. BAZIS Jakarta has semi-government status due to its makeup up of government and community elements. Other provinces later followed the development of state owned zakat organizations. The development of this sector has continued due to the implementation of supporting policies in the early 1990s.

In addition to state owned zakat organizations, privately managed zakat institutions have emerged in the Islamic voluntary microfinance sector in Indonesia. Dompet Dhuafa (DD) is one of the first non-state agencies that has successfully implemented a modern philanthropic style of management. DD was initially a charity function of Republika, an Islamic focused newspaper, initiated by leading journalists in Republika and supported by the ICMI (Ikatan Cendekiawan Muslim Indonesia). The development of DD was motivated by four factors: the poor performance of state owned zakat institutions, a lack of effectiveness and transparency in existing zakat institutions, negligible recognition of zakat as part of the country’s financial system, and the increasing number of famine victims witnessed by Republika journalists in Gunung Kidul Yogyakarta (Helmanita, 2006).

The growth of modern zakat institutions cannot be separated from the implementation of supportive regulations. The first comprehensive zakat law (Zakat Law 38 /1999) encourages the development of a reputable and strong zakat organization. This law requires the organization to provide accurate annual reports on zakat collection and distribution, with the application of penalties if organizations do not provide these reports. This law contains some limitations in that zakat is excluded as part of the country’s financial system, and further, the law does not state what the consequences will be for wealthy Muslims who do not pay zakat. Moreover, zakat activists believe that paying zakat creates a double burden for Muslims as they also have to pay state taxes. In
addition to this law’s limitations, they argue that zakat collection will increase if zakat becomes a legitimate deduction from taxable income. Further critique also raises the issue of the limited roles of the state in managing zakat collection and distribution.

In response to calls for greater legal regulation of zakat, the new zakat law was introduced in 2011. The government has a direct involvement in this Islamic charity sector through its establishment of the National Zakat Institution (BAZNAS – Badan Amil Zakat National). This independent institution plays a significant role in zakat management as the new zakat law clearly states that all activities conducted by zakat institutions have to be reported to BAZNAS. BAZNAS has responsibility for the registration of new zakat institutions and oversees the management of funds collected and distributed by zakat institutions. BAZNAS also has responsibility for the reporting of all zakat activities directly to the President of Indonesia. Further, BAZNAS has a crucial role in addressing any challenges facing the successful management of zakat throughout the country.

The role of the state in zakat management is also reflected in Zakat Law 38 /1999 as zakat organizations have the authority to deduct funds from the taxable income of liable zakat payers. This deduction effectively reduces the double burden on Muslims to pay both zakat and income tax. Although this favorable treatment of taxable income may motivate Muslims to pay zakat via zakat institutions, it may at the same time reduce the country’s total tax revenue. From this, it can be seen that if the government does not manage zakat funds effectively, then benefits to be gained from zakat distribution for the overall society may be limited.

Modern zakat organizations collect shadaqa, infaq and waqf in addition to zakat. Shadaqa, infaq and waqf are not compulsory contributions for Muslims. It is understood that such donations encourage brotherhood in Islam. A recent survey of Islamic voluntary donor practice in Indonesia shows that over ninety percent of Muslims pay individual shadaqa, while only 34.7% pay zakat (Mintarti et al., 2012)

Zakat in Indonesia is managed by three categories of institutions: Badan Amil Zakat (BAZ) as a state owned zakat institution, Lembaga Amil Zakat (LAZ) as a private zakat institution, and Unit Pengumpul Zakat (UPZ) as the appointed agents for zakat.
collection. Currently, BAZ is established in 33 provinces, 277 district level institutions and in 3160 sub-districts. In addition, there are approximately 200 LAZ institutions (IZDR, 2010). There has been a significant increase of the total funds collected from approximately 80 billion rupiah in 2002 to 414 billion rupiah in 2006, with an average annual growth of 51.65% during 2002 to 2006 (Nurzaman, 2011).

The rise of modern *zakat* management can be attributed to several factors. The most significant factor is the supportive role of formal regulations in the management of the Islamic charity sector. Other factors, such as the enduring impacts of the Asian Financial Crisis (AFC) and the need to respond to numerous natural disasters in Indonesia, have also contributed to the development of this voluntary sector (Amelia, 2008). The increasing number of *zakat* organizations in Indonesia has put further competitive pressure on the Islamic charity industry sector in their offering of innovative and distinctive funds distribution programs. This type of pressure forces institutions to innovate in order to attract and sustain donor participation. Microfinance initiative is seen as an innovative program to distribute charity that can attract donor participation.

To explain the participation of *zakat* institutions in microfinance initiatives, this study collected secondary data through the analysis of documents pertaining to the economic empowerment programs of six selected leading *zakat* organizations in Indonesia: Dompet Dhuafa, BAZNAS, *Baitul maal* Muamalat, PKPU, Rumah *Zakat*, and Lazis MU. This analysis shows that these institutions have created many microfinance programs specifically related to economic empowerment. Many of these community empowerment programs focus both on rural and urban areas of Java Island and parts of Aceh. Dompet Dhuafa and *Baitul maal* Muamalat cover some of the provinces outside Java, including Sulawesi, Kalimantan and Papua.

The operations of Dompet Dhuafa, Rumah *Zakat* and PKPU demonstrate that these institutions place significant emphasis on enhancing participants’ skills through their provision of training programs targeted towards their clients’ micro businesses. For example, Dompet Dhuafa provides training for street vendors in how to create healthy snacks for children. This particular training program is not only beneficial for clients but also for the broader society more generally by supporting consumers’ healthy food
decisions. Both Dompet Dhuafa and Rumah Zakat also support the agricultural and animal husbandry sectors specifically in relation to the breeding of ducks, sheep and cows. Dompet Dhuafa’s development of a biological laboratory for the purpose of developing valuable agricultural technologies for the poor, has led to the creation and manufacture of a range of bio-pesticides and organic fertilizers. This laboratory also supports the poor to produce and sell fertilizer in the local market and creates programs designed to help farmers to sell their farm animals through agricultural cooperatives.

In addition to offering skills enhancement training, many institutions provide enterprise financing directly to the poor. Their target clients include micro-entrepreneurs such as petty traders and street vendors. There are three major schemes implemented by these types of enterprise funding: grants, qard hassan mechanisms, and profit and loss sharing mechanisms. Both Rumah Zakat and Dompet Dhuafa provide grant assistance to the poor to enable them to purchase equipment and fixed assets required to start their new ventures. Other institutions such as Baitul maal Muamalat Indonesia, BAZNAS and LazisMU implement interest free financing (qard hassan). Both Baitul maal Muamalat Indonesia and BAZNAS use qard hassan loans for educating the poor in how to get their businesses started. These zakat organizations believe that within a certain time frame, the poor will be more experienced in conducting a business effectively and be ready to participate in more commercially-oriented Islamic microfinance loan arrangements that use profit and loss sharing mechanisms. A major goal of these microfinance schemes is the transformation of zakat recipients (the poor) into zakat payers (the financially better off). Other programs provided by BAZNAS and LazisMu also integrate microfinance practices with other sectors such as education, health, religion, and infrastructure development. These programs aim to achieve sustainable benefits for society.
The use of zakat for microfinance in Indonesia is also well-known as productive zakat. This concept has gained significant attention over recent times. There are a considerable number of studies examining the impact of the use of zakat for increasing welfare assistance for participants, although the scope for this initiative is likely to be limited. For example, Khatimah (2004) studied the impact of productive financing in the Community Development Cycle program in Dompet Dhuafa. Khatimah (2004) explored the influence of gender, education, type of business and amount of zakat.
financing to the per capita income. Khatimah (2004) found that many participants were able to generate substantially increased income after receiving zakat funding. Furthermore, she found that variables such as gender, education level, total zakat received and the clients’ business type, taken together, significantly influenced clients’ income levels. Beik’s (2009) study explored the impact of receiving zakat funding on the welfare of 50 households in Jakarta’s Dompet Dhuafa: before and after receiving zakat. By utilizing several methods of analysis – such as headcount ratio, poverty gap indices, the Sen Index and the Foster, Greer and Thorbecke Index, Beik (2009) found that zakat was able to reduce the number of families estimated to be poor by 10%, reduce the poverty and income gap, and lessen acute poverty conditions. Therefore, Beik (2009) concluded that zakat has a very high potential to reduce poverty in Indonesia.

Although these studies have pointed out possibilities for successful outcomes in the alleviation of poverty through zakat funded initiatives, these studies’ findings may be limited in what they can claim, specifically in relation to comparisons between the welfare status of recipients before and after receiving zakat funds. Studies on the impact of a specific zakat funded program should be conducted for longer time frames, allowing two levels of evaluation: at the beginning of the program and after a specific time period. Asking participants to provide their historical data, such as information relating to income, possibly creates some data bias, as people may not have reliable records of such data.

A recent study by Nurzaman (2011) explores the relationship between the use of zakat and human development. Rather than using economic indicators, he used other indices such as a knowledge index and a life expectancy index. The results contradicted two previous studies by Khatimah (2004) and Beik (2009). He found that using the estimation of Human Development Index (HDI), the HDI of zakat recipients was lower than the average HDI level of the population in Jakarta and Indonesia. Furthermore, he also found that zakat had basically no direct effect on the HDI value of zakat recipients.

A study by Jahar (2010) argues that economic empowerment programs of zakat organizations in Indonesia resemble typical NGO programs in that they put the idea of reformation at the forefront with scant regard to the spirit of Islamic finance. Jahar
(2010) noted that the provision of loans for the productive poor is not feasible as many of the non-productive poor require zakat intervention at the basic subsistence level.

Although ICBM is still in its infancy, it has expanded rapidly due to the expanding Islamic charity sector in Indonesia. Therefore, an understanding of ICBM-related concepts, program implementation strategies, and likely challenges to its sustainability is crucial to enhance the ICBM participation in Indonesian Islamic microfinance sector.

5.4.1.2. Baitul maal

The second actor within ICBM sector in Indonesia is baitul maal. During the early period of Islam, baitul maal was known as an organization that collected state revenue and managed the state expenditure to improve the welfare of the state. It had a role as either a Central Bank or a Ministry of Finance (Yuniarti, 2006). This institution continued to operate during the caliphate era (632-661), and was optimally managed under the second caliph, Umar bin Khabat (634-644). Over this period, the roles of baitul Maal were to collect various state’s sources of revenue including taxes, fees, and Islamic charity. This revenue was allocated for different purposes. Islamic charity was mainly allocated for increasing welfare of the poor; whereas other revenues were utilized to cover various state’s expenditures. In comparison to the concept of baitul maal earlier discussed, baitul maal in Indonesia exhibits different characteristics and plays different roles. In Indonesia, Baitul maal is part of BMT, an Islamic financial cooperative. Baitul maal functions in similar ways to private zakat institutions that manage the collection and distribution of Islamic charity. The functions of Baitul maal are integrated into those of BMT, rather than being managed independently.

The concept of BMT itself was developed to provide services for the society’s grass roots level, as this society level had been previously excluded from becoming Islamic commercial banking clients in Indonesia (Aziz, 2000). Originally, BMT comprised two functions: Baitul tamwil as the commercial function and Baitul maal as the social function. Although both functions should ideally work together in efforts to alleviate poverty; evidence suggests that many BMTs focus only on its commercially oriented function at the expense of its social function (Saifuddin, 2008). This situation may have arisen
because of the need to absorb the higher costs associated with the institution’s social function that possibly threatened BMT’s profitability (Djamal, 2000). Saifuddin (2008) further argues that management’s lack of motivation to better understand BMT’s social function may be a possible reason for why no attention is given to this function. Overall, Yuniarti (2006) study found that on average, the total asset base of Baitul maal is limited as only 5% of the total commercial asset base is held by BMT. Baitul maal’s income is mainly generated from BMT employees’ zakat with limited other income derived from external sources. In practice, there are some BMTs that still maintain both their social and commercial function. These BMTs are in the main generally more established institutions with strong leaders who have made and kept their commitment to serve society.

Baitul maal also offers a similar microfinance scheme to that of zakat organizations. It provides qard hassan loans for eligible zakat recipients in local areas. Baitul maal provides services mainly for clients at lower levels of poverty who have not been targeted by Baitul tamwil, as a commercial unit. The ideal model of the concept of BMT is that of an institution that integrates its commercial microfinance operations with its social services to manage the collection and distribution of Islamic charity (Djamal, 2000, Sumiyanto, 2008). This model is similar to the integration model of Islamic charity in microfinance suggested by Hassan (2010) and Obaidullah (2008).

In order to respond to the research questions in this study, the researcher selected three ICBM institutions representing the zakat organization model and the BMT model. The selected institutions also represent something of the variety of ICBMs flourishing in Indonesia today. Some background on each of the institutions and their microfinance programs is presented in the next section.

5.5. Case study ICBM institutions

5.5.1. Baitul maal Muamalat Indonesia (BMMI)

BMMI, a representative of private zakat organizations, was established in 2000 as a social subsidiary of Bank Muamamal Indonesia that collects Islamic charity from Bank
BMMI’s main program centers on economic empowerment. Seventy per cent of its funds are distributed for this purpose through microfinance programs. The programs include three initiatives: Komunitas Usaha Mikro Muamalat Berbasis Masjid (KUMMM), Koperasi Jasa Keuangan Syariah KUMMM (KJKS KUMMM), and Lembaga Keuangan Mikro Syariah (LKMS). These programs have been designed to run as continuous programs that aim to include the poor within the microfinance system by offering different products and services with different periods of interventions and targeting different client profiles.

BMMI microfinance programs, Komunitas Usaha Mikro Muamalat Berbasis Masjid (Micro entrepreneur community based on mosques/KUMMM), were initially developed in 2007. This KUMMM program is especially designed for micro entrepreneurs who actively participate in the local mosque. The key objectives of the program are firstly, to work toward economic empowerment of the poor and secondly to support religious education for society. This second objective is translated into the institution’s mission statement as an intention to develop an individual character with strong religious beliefs, a determined commitment to grow, and with the capacity to empathize with others. This mission statement emphasizes the need to enhance participants’ wellbeing and to support growth in their understanding of Islam.

BMMI KUMMM microfinance program activities, including client selection, mentoring and loan repayment arrangements are conducted in the mosques. By centralizing these activities in the mosque, the institution believes that it will be able to choose clients who are motivated towards and committed to the adoption of positive attitudes and values. These client characteristics may go some way to reduce asymmetric information and moral hazard problems (S Kalifatullah, 2012). This approach is understood to replicate features of the Al Akhuwat microfinance model in Pakistan.

KUMMM offers a continuation program by establishing financial cooperatives for the community surrounding the mosques, named as Koperasi Jasa Keuangan Syariah (KJKS). This cooperative is registered with the Ministry Cooperative and is regulated as
a semi-formal organization under cooperative law. The members of the cooperative are successful graduates of the KUMMM program. KUMMM management expects that successful graduates will manage their own cooperatives and begin to participate in commercial microfinance. The role of BMMI is to provide the initial capital and to cover initial operating costs, as well as provide training in KJKS’ standard operating procedures. Similar to other financial cooperatives, KJKS also offers various commercial Islamic transaction schemes to cover its operational costs. At this point, continuation program of KUMMM is no longer offering an interest free financing under *qard hassan* scheme.

5.5.2. **Baitul Qirad Baznas**

The second institutional case study presented in this thesis is BAZNAS. BAZNAS is the national-state owned *zakat* institution established in 2000 to manage the collection and distribution of Islamic charity in Indonesia. BAZNAS has a central role in the Islamic voluntary and charity sector in Indonesia as all this sector’s activities, including charity collection and distribution, have to be reported to BAZNAS. BAZNAS subsidiaries, known as BAZDA, are located in provincial and district levels all over Indonesia.

The BAZNAS program covers several areas in education, economy, health and natural disaster assistance. The BAZNAS economic programs are aimed at empowering *zakat* recipients to increase their productivity and income levels by using Islamic charity alone. One of the services BAZNAS provides is the provision of interest-free loans under the Baitul Qiradh Baznas (BQB). The BQB program will be the focus of the analysis and discussion of this case study as it represents an exemplar institution in relation to its Islamic charity funded microfinance programs.

The BQB microfinance program was developed in February 2010. In its early development, BQB was a semi-autonomous institution off-shoot of BAZNAS affiliated with PT WIN and KMU MAS Berlian. PT WIN and KMU MAS Berlian collaborated in the establishment of BMT ONE as an institution that provides management, systems operations and information technology services for the BQB, while BAZNAS provides funding sources for BQB operations.
During 2010, BQB’s operations were profit oriented. Using commercial Islamic transaction schemes, BQM distributed its funds from infaq and sibadaga in the form of microloans for the poor. At that time, BQB was experiencing problems as they were attempting to achieve profitability under the constraint of poor clients who were often facing difficulties with their loan repayments. As a result, the number of non-performing loans in BQB was very high. Latterly, BAZNAS management considered re-orienting BQB’s mission from being a commercial microfinance institution towards a voluntary microfinance institution.

The re-orientation of BQB began in early 2011. Since then, BQB has taken a position as a mentoring institution that provides Qard hassan loans and personal mentoring services (BQB-1, 2011). This program aims to assist zakat recipients raise their income levels, strengthen their work ethos, and reduce their dependency on informal money lenders.

5.5.3. Baitul Maal Beringharjo

Mursida Rambe and Nanawati initiated the development of BMT Beringharjo in Yogyakarta in 1994 with support from Dompet Dhufa – a national private zakat organization. This organization started the Baitul maal with a small amount of initial capital (one million rupiah) and with limited infrastructure resources. The first office was located in the rear building of Muttaqien Mosque next to Yogyakarta’s central Beringharjo Market where many market traders were burdened with exorbitantly high interest rates on loans provided by informal money lenders. Highly motivated to help the poor, BMB offered interest free loans to the poor market traders. By 2011, there were approximately 6000 of a total of 8000 traders actively participating in BMT Beringharjo microfinance programs.

BMT Beringharjo has successfully managed 11 baitul tamwil (BTB) as commercial institutions with one baitul maal (BMB) located in the Yogyakarta Head Office. BMT Beringharjo has demonstrated substantial growth to become a successful microfinance institution. In 2009 it assets reached 31 billion rupiah, it employed 107 staff, and its operations covered eight districts in provincial Java.
Similar to the other commercial microfinance institutions, BMT Beringharjo offers savings and financing products using Islamic schemes of transaction. In addition, it also offers investment schemes to generate funding for the institution’s expansion. BMT Beringharjo’s investment scheme, named Beringharjo Investasi Syariah (BISA), is one of its most innovative microfinance products that specifically targets Indonesian laborers who work overseas, such as Indonesian housemaids employed in Hong Kong. The overseas laborers are encouraged to become investment partners in the establishment of new BMT branches in their hometowns in Indonesia. This scheme has led to the successful development of new BMTs in several districts in East Java, such as Ponorogo, Madiun, Kediri and Bandung in 2008 (Juwaini et al., 2010, Sakai and Marijan, 2008).

BMT Beringharjo is one of the examples of BMTs that maintains the existence of Baitul maal as the social unit to serve the community. The role of Baitul maal is to collect Islamic charity from BMT Beringharjo clients and stakeholders of BMT Beringharjo, which will be distributed for empowerment programs for the poor. In BMT Beringharjo, baitul maal (BMB) as a social function, constitutes a division under direct supervision of the BMT director. BMB represents one of the models of ICBM in Indonesia. Unlike the other voluntary microfinance models presented in the previous chapter, this voluntary microfinance institution works within BMT as the commercial arm of a cooperative type of microfinance institution.

From 1994 to the present, products and services offered by BMB have evolved significantly in response to market driven demands to offer improved empowerment programs. From 1994 to 2002, BMB offered only qard hassan loans. This type of loan is provided on an individual basis and as such, without any additional group mentoring. Mass mentoring was given to provide religious education and to build connections between clients and the institutions. BMB management argued that mass mentoring on its own was not capable of empowering the poor, thus the institution developed the idea of group mentoring in 2002. Individual qard hassan loan schemes and mass mentoring were terminated and replaced by a package of services that focus on three areas: economic empowerment, client development, and charity programs.
The BMB’s economic empowerment programs target the poorest level of the poor and have an important role to play in both preparing members of this client group to become more entrepreneurial in their outlook and in expanding opportunities for their financial inclusion. The BMB programs are conducted in three phases. In the first phase, Sahabat Ikhtiyar Mandiri (SIM) is offered for the poorest level of the poor. In the second, Sahabat Mudharabah Kebajikan (SMK) targets graduates of SIM programs, and in the third phase, Mentas Unggul, an advanced empowerment program, selects the best SMK graduates to be coached as entrepreneurs. Each program in each phase targets different clients and is designed to achieve different objectives. After having participated in a series of economic empowerment programs, the graduates of these advanced empowerment programs are expected to be clients of Baitul tamwil.

In addition to the provision of services to the poorest and the poor, Baitul maal also offers some development programs for Baitul tamwil clients who are mainly new entrepreneurs with a small asset base. One of these programs, BINAR, offers direct assistance in book keeping and professional skills enhancement training. This free service of BMT assists new entrepreneurs to grow and reach their potential. BINAR graduates developed Binar Family (BIFA) as an ambassadorial program that represents and is run by successful participants. Operating independently, this program’s periodic meetings help BMT Beringharjo to reach more customers. BINAR graduates also volunteer to become casual trainers for other empowerment programs. Depicted in the Figure 5.1, these particular programs can be seen as a cycle of intervention that complements each other. This model shows how in concert, BMT’s social functions can be advantageous to commercial functions, and vice versa.
Figure 5.1. The cycle of BMB’s programs

<table>
<thead>
<tr>
<th>Provider</th>
<th>Product and Services</th>
<th>Clients</th>
</tr>
</thead>
<tbody>
<tr>
<td>Baitul maal</td>
<td>SIM/ benevolent loan</td>
<td>The poor and extremely poor</td>
</tr>
<tr>
<td></td>
<td>SMK/Profit sharing</td>
<td></td>
</tr>
<tr>
<td></td>
<td>BINAR/Professional</td>
<td>The non-poor</td>
</tr>
</tbody>
</table>

Source: interview data

The *Baitul maal* model is included in this study as it represents an approach to the integration of Islamic charity and microfinance. It shows how a commercial institution’s social function can support the development of the whole institution, without endangering institutional sustainability.

### 5.6. Conclusion

This chapter discussed the development of Islamic microfinance in Indonesia with a particular focus on the ICBM practices. It also introduced and located the case study institutions within this system. This chapter showed that Islamic finance principles have been incorporated into microfinance practice in Indonesia since the 1980s, earlier than the development of the first Islamic banks in 1991. Interestingly, it also identified the long history of the use of Islamic charity in microfinance; first evident in early part of the 18th Century when Raden Aria Atmaja used mosque funds for the provision of credit for civil servants in Purwokerta. Although, Islamic microfinance has been established for decades, current development of this financial sector remains sluggish. Several challenges have been identified as major barriers to further growth, including a lack of a sound regulatory framework, weaknesses in supervision processes for the non-banking microfinance sectors, and low levels of demand from the community.
Four types of institutions deliver Islamic microfinance in Indonesia: Islamic commercial banks, Islamic rural banks, Islamic financial cooperatives, and ICBM. These institutions provide diverse financial products and services to a diverse target market under profit and loss sharing mechanisms. In contrast, ICBM provides interest-free financing under *qard hassan* loan for clients who have been excluded by other microfinance providers.

Two types of institutions in Indonesia are engaged in the provision of ICBM: *zakat* organizations and *baitul maal.* The increasing popularity of ICBM in Indonesia may be explained by the significant growth of the Islamic voluntary sector that pressures institutions to implement innovative donor participation strategies. The distribution of *zakat* in productive ways, such as through microfinance products and services, is considered a robust strategy to strengthen *zakat’s* intention to enhance the wellbeing of microfinance recipients.

Lastly, this chapter has introduced the three institutions included in the case study. The institutional sustainability and outreach of those institutions will be evaluated in the following chapters.
Chapter 6

Examining the sustainability of Islamic charity based microfinance in Indonesia

6.1. Introduction

This chapter presents research findings on the institutional sustainability of Islamic charity based microfinance (ICBM) in the form of a case study analysis. Sustainability in this thesis is defined as the capability of institutions to survive and continuously serve their constituencies (Weerawardena et al., 2010).

As introduced in the previous chapter, three ICBM institutions were selected as case study samples. The first institution selected was Baitul maal Muamalat Indonesia (BMMI), representing a national private zakat organization. The focus of this case study analysis is BMMI’s microfinance program around mosques. From the time this program was established in 2007, it has delivered non-profit microfinance services in 21 provinces in Indonesia. The second institution selected was Baitul Qiradh Baznas (BQB), representing government zakat organizations. BQB’s microfinance program was initiated in 2010, and has provided microfinance services in the Jakarta area, and in West and Central Java. The third institution selected was Baitul Maal Beringharjo (BMB), a social subsidiary of the financial cooperative, BMT Beringharjo. BMB is a local ICBM institution that provides microfinance services in Yogyakarta.

Each case study was analyzed using primary data derived from interviews with each case study organization’s staff members, and secondary data generated from the content analysis of institutional reports. This chapter is structured as follows: Section 6.2 discusses the general operations of the case study ICBMs; Section 6.3 examines factors affecting the sustainability of the case ICBMs; Section 6.4 describes relationships between these factors to examine issues around achieving and maintaining institutional sustainability; Section 6.5 discusses the unregulated nature of the ICBM sector and the
impacts this has on institutional performance; and the concluding section draws together overall findings from the case study analyses.

6.2. The services of ICBM

ICBM is a type of microfinance that utilizes Islamic charitable funds to provide a combination of financial and non-financial resources for poor clients. Financial services include benevolent loans and voluntary savings facilities and non-financial services that include mentoring, education and health programs.

6.2.1. Benevolent loan/ Qard hassan

The main service of ICBMs is to provide their clients with benevolent loans or qard hassan. This particular loan scheme requires ICBM clients to repay the loan financing at the similar amount of the principal within a specific time period.7 This loan financing strategy is intended to assist zakat recipients to gain access to capital for developing their own micro-enterprises. The objectives of this loan service are to empower and transform zakat recipients into zakat payers themselves.

Compared to loan services offered by other microfinance providers in Indonesia, ICBM’s services demonstrate four key distinctive characteristics. First, the average amount of financing is very low, ranging from 500,000-2,000,000 rupiah per client (around $76-$304).8 Such low average loan balances indicate that these institutions likely target very poor clients. Secondly, these ICBM loans are short term in nature with full re-payment expected within eight months to two years. Third, ICBM institutions provide mentoring and supervision services as complementary programs to assist clients to successfully manage their loan funds. Fourth, although ICBM services are conducted on a voluntary basis and are free of charge; BMMI requires clients to pay a small compulsory group fee of 3,000 rupiah ($0.45) to attend weekly group support meetings.

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7 From the economist point of view, interest free financing can be seen as negative interest spread due to the inflation rate.

8 Conversion rate used for data analysis is calculated using purchasing power parity rate ($PPP) provided by BPS in 2012 at 6575 rupiah.
This group fee is intended to cover operational costs for the second year of the program.

When clients have re-paid their first loan, BMB and BMMI allow clients to obtain a ‘second round’ loan of a higher amount. Interestingly, the BMMI’s program reports show that only half of the participants in the first round of loans allocations take up the offer of a second round of financing (BMMI, 2011). This lower rate of participation may be due to prospective second round borrowers’ hesitancy to take up a loan with requirements similar to commercial loan types. Presumably, they would prefer the same loan conditions as those attached to the initial interest free loan.

All case study institutions apply individual lending strategies. Both BMMI and BMB borrowers are managed in client groups of between five to ten members. Group meetings are intended to promote mentoring activities, and to organize loan installments and savings collections. BMMI and BMB have not adopted the standard Grameen model of group lending that requires borrowers to select group members by themselves and that stipulates that group members are jointly liable to repay each borrower’s loan. Rather, in these case study institutions, group members are selected by the institutions on the basis of clients’ geographical locations in order more conveniently schedule group meetings and to minimize travel costs. To enforce loan repayments, BMMI and BMB have a specific mechanism in place known as the tanggung renteng mechanism.

Interestingly, both BMMI and BMB have different interpretations of the tanggung renteng concept. BMMI’s ‘ideal’ concept of tanggung renteng is realized in instances where, if a group member cannot repay their loan, then the group will assist that member with their loan repayments. This member will not be excluded from the group until their loan repayments defaults three times. For BMB, the concept of tanggung renteng is interpreted as the situation that arises when a group member cannot repay their loan and, as a consequence, other group members cannot obtain a second round of loan financing until all the group members’ loans are fully repaid. BMB does not want to force group members to repay other members’ loans that have fallen into re-payment arrears.

In responding to interview questions related to the enforcement of the tanggung renteng mechanism, the management staff of BMMI indicates that tanggung renteng is rarely, if
ever enforced as such loan programs are funded by *zakat*, which is intended to be given directly to the poor. As one BMMI’s management staff argues:

> We are a voluntary microfinance, this is not bank… This money is their money that comes from *zakat*… we communicate it as loan to educate them; so they can grow, from the assets sides, the business side, and religious side. The main purpose of this program is for support the development of mosques, increasing the religious value of the participants as well as developing their business (BMMI-1, 12 Dec 2011)

In relation to loan re-payment arrangements, two methods are used. Within both BMMI and BMB, group meetings provide a convenient time and location to collect loan repayments. Before the meeting starts, clients are required to pay their loan installments directly to the group mentor. This arrangement encourages clients to repay their loans on time. Seeing other clients paying their loan seems to be a powerful motivator to encourage all group members to do likewise. In contrast, BQB has adopted direct personal loan collection strategies in that the loan officer visits borrowers’ homes by motorcycle on a monthly basis to collect loan payments. This method is less efficient as it requires substantial additional costs in time and travel expenses. Evidence from the observations of BQB’s loan collections in Bojong Gede West Java shows the loan officer often returns to the office empty-handed as a result of not having collected any loan re-payments.

### 6.2.2. Voluntary savings and donations

Although it is not compulsory for ICBM’s clients to save some of their income, deposits into ICBM clients’ saving accounts are encouraged. Differently to the other two case ICBMs, BMB and BQB that do not stipulate an amount to be held in a savings account, BMMI collects a savings deposit of a minimum of 2,000 rupiah, or around $0.30 from each client at every meeting. Such savings are used to fund education programs that promote the importance of asset accumulation, rather than as back-up funds for non-performing loans.

Client savings cannot be easily withdrawn at any time. They can only be withdrawn for critically important purposes such as for business expansion and educational purposes.
These savings are kept either in accounts within financial cooperatives or Islamic banks and in this way, these institutions encourage their clients’ effective participation in commercial finance practices.

In addition to promoting savings practices, BMMI also encourages participants of loan programs to donate to others. Donations, set at 1,000 rupiah per week per loan client are collected at every group meeting. The objective of the donation program is to educate participants to understand that even though they are poor, they can share some of their money with others. A BMMI mentor notes that this donation practice is centered on a verse in the Qur’an that states that God will pay back the donation at higher amount (BMMI-2, 16 Dec 2011).

6.2.3. Periodic mentoring programs

Mentoring has developed as an important activity in each of the three case study institutions. Mentoring plays a crucial role in educating clients about the benefits of a disciplined and motivated business approach to the running of their microenterprises. The mentoring process may also encourage some clients to change their mindset about poverty. The ICBM institutions argue that the provision of loans as start-up capital will not necessarily bring about changes for the better unless clients also undertake educational training programs provided by their ICBM institution. This argument points out a key difference between ICBMs the commercial microfinance sector.

From the case studies, there are two different mentoring approaches available to ICBMs: direct personal mentoring and group mentoring. Direct mentoring is implemented by BQB, while BMMI and BMB incorporate mentoring initiatives within their group meeting structure. The objectives of BQB’s personal mentoring approach are to motivate and educate their clients on how to start a micro business. The BQB mentor is responsive to individual client needs and questions and as such, BQB does not set down specific mentoring guidelines to be followed, or determine which business-related topics should be discussed. As one mentor put it:

For me being a mentor is being a consultant, I have to give support, suggestions, ideas, problem consultation, and personal approach to the clients. They don’t know how to
use the money, manage the cash flow and sell the products. This function is really crucial for the success of the program (BQB-2, 8 Dec 2011).

BQB requires its clients to prepare a business proposal that identifies the nature of the proposed business, a marketing and financial plan, and an estimate of the amount of funding they require from BQB to fund the proposed business. Clients can seek assistance from BQB fieldworkers and their family or friends in the preparation of their proposal. The management of BQB argues that the actual process of developing a micro business proposal may enhance clients’ prospects of business success. Up to the end of 2011, BQB had not provided any specific skills enhancement training. BQB notes that personal individualized mentoring activities, rather than group training, may be the best way to optimize clients’ business success due to the diversity of the clients’ micro business knowledge, experiences and motivation levels. Further, BQB mentions that the inaccessibility of geographically challenging locations presents significant barriers to group mentoring programs. In the field, some clients on their own initiative have formed informal groups that are used to collect loan repayments.

In contrast to BQB’s mentoring program, BMMI and BMB utilize periodic group mentoring meetings, weekly in BMMI’s programs and fortnightly in BMB’s. The institutions’ mentors supervise these periodic mentoring meetings. Both BMMI and BMB have developed training modules that cover several business-related subjects such as entrepreneurship, micro-enterprise management, financial and marketing management, the Islamic economy, leadership training, and religious education. These modules are incorporated into the group mentoring meeting schedule. The BMB training module emphasizes spiritual training rather than management-related training. The module also highlights the importance of a strong work ethos. For example, mentors teach about Prophet Muhammad’s success in the business sector. In practice, this particular religion-oriented module is conducted with considerably more flexibility in order to increase participants’ interest in and motivation to attend the meeting (BMB-3, 15 Dec 2011).

Group meetings are conducted in the mosque, or in one of the group member’s homes. Taking participants’ attendance at the weekly meetings means that attendance numbers
can be monitored and used as one of the mentoring program’s success indicators. In 2010 the average weekly attendance for BMMI programs was 69% comparable to the average fortnightly meeting attendance for BMB’s programs was 60-70%. With the meetings beginning at 4p.m., participants working at this time may not be able to attend. Such time constraints may constitute a major obstacle in the overall success of the program. Attendance at weekly meetings demands a significant time commitment on the part of both clients and mentors, with the meetings themselves incurring additional operating costs. The study’s interview data show that the ratio of mentor per client is very high. For example, there are only two fieldworkers employed by BQB to assist approximately 600 clients. Similarly, there are only two mentors serving approximately 300 clients within BMB’s empowerment programs. These ratios mean that field workers and mentors are expected to work longer hours and manage their time efficiently and effectively. As one mentor recalled:

Every Monday to Wednesday, after office hours, I have to collect the loan repayment; sometimes I can get home by 9 or 10 pm; and every Thursday and Friday I have to conduct monitoring programs. It is impossible for us to cover all the areas. BAZNAS has to be more generous for this program if they want this to be successful (BQB-2, 8 Dec 2011)

In the particular case of BMMI, with its national microfinance network, the management staff interviewed stated that finding ways to make regular group meetings viable has become a major issue over recent years. In the years between 2007-2010, local mentors organized the group meetings and recruited participants using the recommendation from local religious leaders. For BMMI, this recruitment strategy raised a number of significant concerns. These concerns related to the high degree of subjectivity and conflicts of interest on the part of some mentors in the selection of participants, and to a perception that some mentors lacked commitment and loyalty. This situation led to the resignation of a number of BMMI mentors. In the most serious case, it was revealed that some unscrupulous mentors had diverted and illicitly used program funds. To address such challenges, in 2010 BMMI attempted to strengthen collaborations between local microfinance institutions by inviting them to organize group mentoring meetings. However, cost pressures led to the termination of these attempts to build collaborative partnerships. Another significant change to the mentoring process occurred in 2012 when BMMI management began to develop partnerships with Microfin, an independent
microfinance consultant as a strategy to renew and reinvigorate the weekly group meeting and mentoring program initiatives (BMMI-1, 12 Dec 2011).

6.2.4. Advanced programs

Once clients had completed the benevolent loan programs, both BMMI and BMB offered their clients advanced programs on a continuing basis to enable them to further develop their fledgling microenterprises. The next discussion focuses on BMB’s and BMMI’s advanced continuation programs. This discussion is followed by an explication of BQB’s support programs.

The graduates of BMB’s benevolent loan programs are generally invited to apply for a larger amount of loan financing (e.g., 1,000,000 to 1,500,000 rupiah, or $152 to 228). Unlike the clients’ first smaller loans, these larger loans implement Islamic commercial scheme of transaction, particularly profit loss sharing schemes. Further, clients are required to share their profits and losses to the institution. Every month the mentor assists the clients to estimate their profits and losses and share 2%-3% of their profits and losses to BMB as the lender. The aims of these loan programs are to familiarize participants with commercial banking contexts in advance of participants becoming commercial microfinance clients.

BMB management staff interview responses indicate that the majority of benevolent loan participants are reluctant to participate in these commercially-oriented loan transactions as they prefer smaller interest-free loans and simpler record-keeping responsibilities (BMB-1, 14 Dec 2011). That commercially schemed loan clients are required to record all transactions and provide regular financial statements, present further pressures. According to BMB management staff, clients often relate something of the everyday struggle to sustain their micro business, as one management staff member said, ‘for the clients, profit is when they can still buy the inventory for selling tomorrow’ (BMB-1, 14 Dec 2011). This statement indicates that for struggling micro enterprise owners, the notion of making a profit is a relatively short lived one. For some clients, it might be difficult to envision what the outcome might be for their business, if under commercial loan conditions; the profit-making period is fleeting. This limited
clients’ future orientation may explain their hesitancy to participate in commercial transactions.

Loans made through profit-loss sharing types of financing have to be repaid in one year. After this time, participants are expected to be ready to participate in the commercial microfinance sector. BMB management found that some clients lack the confidence needed to develop their businesses and participate in commercial microfinance. Thus, BMB management initiated a one-year advanced loan bridging program that provides larger loan amounts to around 3,500,000 rupiah annually, approximately $532. This advanced loan initiative also provides personal mentoring activities and customized training programs that reflect individual client’s unique needs and circumstances. The aim of the advanced loan program’s personal support resources is to elevate participants’ confidence and enhance their specific business-related skills.

Taking different strategy, BMMI offers “an exit program” for high performing participants through its initiation of a financial cooperative. Located in a local mosque, this cooperative receives its initial capital funding through funds collected from loan repayments made under benevolent loan programs. The management of BMMI argued that as the benevolent loan programs were funded by zakat contributions, re-paid loan monies must be given back to the poor in accord with sharia law (BMMI-1, 12 Dec 2011). The development of financial cooperatives for successful benevolent loan participants reflects BMMI’s efforts to minimize possible infringements of tamlik guidelines. By 2012, BMMI had established 11 financial cooperatives across Jakarta, Semarang, Surabaya, Palembang, Ternate, Sorong, Pontianak and Makassar.

By contrast, although BQB is the only microfinance institution that does not provide continuation programs of the type described above, BQB clients can take advantage of other programs offered by BQB’s major institution of BAZNAS. The management of BQB notes that its overall services are well integrated and that prospective clients have unconditional access to other BAZNAS social services. On the availability of BAZNAS social services, a BQB management staff member related: ‘When the clients of BQB have health problems, we usually refer them to rumah sehat BAZNAS, or when they
have difficulties to pay the kid’s school fee, we can refer them to scholarship department (BQB-1, 8 Dec 2011).

Overall, the microfinance programs offered by ICBM institutions demonstrate similar characteristics in that they all provide benevolent loans and periodic mentoring programs, and encourage voluntary saving. Further, the case ICBM institutions provide continuation programs and other non-financial related services. Their programs have been designed for very poor clients who have limited skills and resources to run a microenterprise. The institutions also provide sequential services that enable clients to access further financing and to eventually graduate from poverty. A summary of key institutional program characteristics generated from the interviews is presented in Table 6.1.
<table>
<thead>
<tr>
<th>Loan type Characteristics</th>
<th>BMMI</th>
<th>BAZNAS</th>
<th>BMB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qard hassan</td>
<td></td>
<td>Qard hassan</td>
<td>Qard hassan</td>
</tr>
</tbody>
</table>

| Savings services          | Voluntary | Voluntary | Voluntary |

| Compulsory fees           | 3000 rupiah per group per meeting to cover operational costs | No | No |

| Infaq and Sadaqa (voluntary donations) | Intention to teach participants to share with others | No | No |

| Training and Mentoring     | Weekly group meetings  
Meeting topics: Islam, the economy, marketing and personal finance | Personal mentoring: problem solving and individual consultancy  
Weekly group meeting (spiritual training 70%, development of management skills 30%) | Weekly group meeting  
No group |

| Continuation program       | Financial cooperatives | Profit-loss sharing loan schemes with higher amounts of loan financing  
Personal mentoring |

| Main function of client groups | Running weekly meetings, collecting loan repayments and savings deposits | No group | Running weekly meetings, collecting loan repayments and savings deposits |

| Other services             | Possibility for participants to utilize other BANZAS services of (e.g., health and education) |

| Mechanism to overcome bad debts | Tanggung renteng | Tanggung renteng |

Source: ICBM interview data
6.3. Factors affecting the sustainability of microfinance institutions

Using the theoretical framework developed in Chapter Three, this section discusses factors affecting microfinance institutions’ sustainability. The theoretical framework was used as an analytical tool to interpret interview data related to ICBM key success factors and key challenges that play into the achievement of institution sustainability. Discussion in this section focuses on the in funding generation, innovation, community partnerships and support, accountability, operational costs, loan repayment rates and sharia compliance.

6.3.1. The ability to generate funding

The study’s document analysis of the ICBM institutions’ financial reports showed that the overall amount of ICBM funds collected increased significantly between 2011-2012. In less than one year BMMI alone experienced a substantial increase in the amount of charitable funds collected by 16.88 billion rupiah, while over the same period, funds collected by BAZNAS increased by only 0.22 billion rupiah. Table 6.2 provides the 2011 and 2012 funding composition data of BMMI and BAZNAS. Details of BMB’s funding sources are not included in the table as its financial reporting period did not coincide with that shared by BMMI and BAZNAS.

As subsidiaries of commercial financial institutions, BMMI (a subsidiary of Bank Muamalat Indonesia) and BMB (a subsidiary of BMT Beringharjo) enjoy some advantages. Both institutions benefit from the continual flow of Islamic charity funds from the main microfinance institutions’ clients and employees to BMMI and BMB. As one BMMI manager observed: ‘We do not work hard on fundraising. Even though we are sleeping; we are lucky that the funds from Bank Muamalat continuously come to us’ (BMMI-1, 12 Dec 2011). Similarly, BMB also receives regular funds from employees’ salaries and clients’ zakat donations that are deducted monthly from their incomes that on average ranges from five to ten million rupiah each month (BMB-1, 14 Dec 2011).

The breakdown of funding sources reported in Table 6.2 shows that BMMI and BQB are funded primarily by zakat funds. This finding suggests that zakat is the most popular
type of charity collected by the case study institutions, with more limited funding collected from *shadaqa* and *waqf* sources. A possible reason for disparities between the amounts collected from these charitable funding agencies could be that other types of charitable funds, such as *shadaqa*, are usually voluntarily donated directly to close neighbors and family for more individual personal purposes.

Table 6.2  ICBM providers’ funding sources

<table>
<thead>
<tr>
<th></th>
<th>BMMI</th>
<th>BQB</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>December 2011</td>
<td>June 2012</td>
</tr>
<tr>
<td>Amount In billion Rp (%)</td>
<td>Amount In billion Rp (%)</td>
<td></td>
</tr>
<tr>
<td><strong>Zakat</strong></td>
<td>17.59 (77)</td>
<td>24.4 (61)</td>
</tr>
<tr>
<td><strong>Infaq, Shadaqa, Waqf</strong></td>
<td>1.25 (5)</td>
<td>8.87 (24)</td>
</tr>
<tr>
<td>Non-halal income</td>
<td>4.1 (18)</td>
<td>5.6 (14)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>22.94 (100)</td>
<td>39.82 (100)</td>
</tr>
</tbody>
</table>

Source: Author’s compilation from institutional reports

By contrast, BMB collected more funds from *shadaqa* and *infaq* than from *zakat* such that BMB’s funding base is made up of 60% *shadaqa/infaq* funds with 40% derived from *zakat* sourced donations (BMB-1, 2011). BMB’s *shadaqa* collection amounts to 350-400 million rupiah a year ($53,232 to $60,837). The significant amount of *shadaqa* and *infaq* funding comes predominantly from private companies’ Company Social Responsibility (CSR) funds. BMB has been able to develop and sustain good relationships with these private companies to generate substantial, if at times irregular, contributions from CSR funds. As a consequence, BMB can report that it has sufficient funds to resource all of its programs and still maintain a funding surplus. This surplus allowed BMB to establish four new clients groups every month in 2012.

Overall, Table 6.2 shows that ICBMs managed by *zakat* funded organizations depend on *zakat* donations as their main funding source, while ICBMs that are run as financial
cooperatives are advantaged by additional funding generated through voluntary types of Islamic charity and CSR programs. These findings are interesting in that they will enable the researcher to investigate whether or not institutions dependent on zakat funding face more constraints in their financing of microenterprises compared to other institutions less dependent on zakat.

As discussed in Chapter Three, the use of zakat in microfinance remains the subject of much debate among Islamic microfinance scholars. At the center of these debates is the key issue related to how program objectives can be met given strict sharia rules governing zakat distribution. Efforts to comply with these rules represent a significant potential challenge to the achievement of institutional sustainability. This issue will be further addressed throughout the thesis.

6.3.2. Innovative institutional strategies

The development of innovative strategies is critical for strengthening overall institutional strategic capability and competitive advantage. Individually, institutions may select quite different operational areas in which to explore opportunities for developing creative innovative practices, products and services. To exemplify, BQB focuses on developing innovative fundraising strategies, BMB emphasizes product development and maintaining existing donors’ partnerships, while BMMI is concerned with reducing its dependency on Islamic charity by developing a profit entity within its non-profit organizations.

Taking the first example, BQB has implemented several innovative ideas related to fundraising strategies that offer convenient and flexible donation methods. The development of strategies to make it more convenient to make charitable donations is one of the key success factors in reaching Indonesia’s middle class income earners as potential donors (see Eddy and Pratignyo, 2012). Convenient fundraising strategies implemented by BQB include the development of a more efficient monthly zakat payroll deduction system and a zakat ‘pick up’ system. The new payroll deduction system was made possible through BQB’s affiliations with private and public institutions. Through this strategy, employees of affiliated institutions are required to sign a contract that
confirms employees’ willingness to allow 2.5% of their monthly salary to be deducted and then paid directly to BQB. The zakat ‘pick up’ fundraising initiative offers a free zakat collection service from the zakat donor’s location. These innovative more efficient fundraising systems offer prospective donors flexible and convenient ways to contribute to charitable institutional funding and as such, may in themselves attract greater donor participation.

For BMB, intensified efforts to develop innovative economic empowerment programs may enhance donor participation if potential donors perceive these programs to be effective in producing intended outcomes. In the management staff interviews, some stated that fundraising is not the institution’s main concern as it has limited human resources to carry out fundraising activities (BMB-1, 14 Dec 2012). Others asserted that innovative and strong economic empowerment programs are financially more efficient as direct fundraising efforts incur additional investment costs (BMB-1, 14 Dec 2011).

One of BMB’s strategies to develop more innovative programs is the use of English terminology for program branding. From what the interviewees had to say, the use of English in institutional marketing contexts is perceived to be more sophisticated, and therefore programs with English titles are more likely to attract donor participation. Another innovative strategy adopted by BMB is the development of its ‘Greeting the zakat payer’ program (Salam Muzakki). This program revolves around the concept of Customer Relationship Management (CRM) to maintain donor loyalty to the institution. In its implementation, this strategy works to sustain good relationships with existing donors by organizing donor gatherings and inviting their participation in the organization’s social events. It also encourages volunteerism within client empowerment programs. Further, BMB’s waqf certification to manage the collection and distribution of waqf assets has meant that it now has the means to use waqf funds in their innovative empowerment programs. The establishment of an animal husbandry village that provides opportunities and technical assistance for the poor to learn about and become skilled in livestock farm management is one example.

Different innovative approaches are evident in the case of BMMI. Its strategic focus on reducing its dependency on Islamic charity for program funding has meant that BMMI
has needed to generate more flexible and sustainable funding sources to strengthen long term sustainability. Although BMMI operates on a non-profit basis, the institution believes that the adoption of a profit-making approach within its non-profit institutions will generate the funds needed to move the institution towards achieving higher levels of sustainability. The management of BMMI has implemented two profit generation strategies. Although these strategies are not related to the institution’s microfinance operations, profits generated from these will be used to support BMMI’s microfinance programs. The first profit generation strategy relates to the development of a coffee bean distribution network. The underlying intention of this network development strategy is to generate profits through the engagement of its microfinance program clients in coffee bean sales distribution channels throughout Indonesia. Currently, through BMMI management’s affiliation with coffee bean producers, BMMI has built a competitive coffee distribution channel using its client network. The establishment of the institution’s profit entity PT Amanah represents a second strategy for generating additional funds. This entity was formed as a public corporation offering financial services as its core business. All proceeds from this private entity are used to increase the capital base of BMMI.

6.3.3. Community partnerships and support

A microfinance institution’s community partnerships constitute a key resource in institutional efforts to achieve sustainability within the ICBM sector (Kaleem and Ahmed, 2009, Khan, 2011). This study found little evidence of supportive community partnerships in zakat-funded case study ICBMs.

Baitul Qirad Baznas (BQB) once enjoyed partnerships with PT WIN and KMU Mas Berlian to develop financial cooperatives. However, these partnerships were terminated due to different institutional mission orientations. Currently, many programs are managed solely by BQB. Within BMMI, program affiliations with several local microfinance institutions and local government owned zakat organizations turned out to be temporary due to significant cost inefficiencies. In contrast, BMB has continued to receive substantial support through its affiliations with private companies and community organizations such as Dompet Dhuafa, Permata Syariah, Pertamina,
Amikom. Along with private company support, BMB are also affiliated with the religious organizations, Tangan Ditas, Jamaah Khusnul Khatimah, Nurani Insani, Dewi Khadijah and Sakinah. These organizations contribute Company Social Responsibility Funds to BMB’s programs and make additional irregular donations.

According to BMB’s management staff, the task of attracting adequate funding for client empowerment programs has proven to be more difficult. It seems that donors prefer to donate to programs that have direct observable impacts such as the immediate provision of clean water and natural disaster assistance, than to the funding of benevolent loans for the poor. To promote a better understanding of how the institution’s empowerment programs contribute to a productive economy, and in the process possibly attract more funding, BMB conducts community microfinance education programs within mass religious training events.

The study also found instances of community support from community leaders and members in the form of other activities. Firstly, BMMI receives on-going support from the local religious leader who allows BMMI to use the local mosque as a central venue for BMMI’s microfinance programs. The use of the mosque for group meetings and for client selection and monitoring activities has significantly reduced BMMI’s operational costs. Second, from the interview responses the study identified various forms of community support within BMB’s programs. As examples, the Association of Yogjakarta Dentists provides free dental checkups for BMB’s clients in Yogjakarta and the Dewi Khatijah organization supports BMB’s empowerment programs through its provision of food stalls and working capital for the jobless to enable them to initiate their own micro-businesses. Thirdly, as another form of support, successful BMB program graduates volunteer in BMB’s mentoring program. The overall study findings indicate that the community has very limited volunteer involvement in ICBM programs and as such suggest there may be room to further develop volunteerism as a means to achieve institutional sustainability.
6.3.4. Accountability

In Indonesia, demands for accountability in the Islamic charity sector are clearly stated in article 19 Zakat Management Law 23/2011. This law requires all private zakat institutions to provide audited periodic financial statements to BAZNAS as the state controller of zakat funds management. The law has been received positively by the zakat institutions. Zakat institutions also make their periodic audited financial statements available for public download and provide program information on their websites. As noted by Courney (2002), these demonstrated accountability efforts may lead to an increase in donations to zakat. In contrast, the study did not identify any accountability measures within BMB as their financial reports are not publicly accessible to all stakeholders.

6.3.5. The composition of operational costs

One of the challenges in serving the very poor are the high operational costs (Armendáriz and Morduch, 2005). This study found that BQB and BMMI also face this challenge. In the case of BMMI, its financial reports indicate that in 2011, total operational costs amounted to 2.6 billion rupiah, or almost 41% of its total financing. As mentor-supervised weekly client meetings incur significant operational costs, the use of a local mosque as the central venue for the institution’s programs can reduce additional program-related overhead costs. However, factors related to meeting frequency and the mosque’s location, particularly if distant from the institution’s main office, need to be considered in any cost-savings calculations.

In the case of BQB, total operational costs for 2011 were 181,082,321 rupiah, significantly higher than its total revenue of 77,368,406 rupiah. Possible reasons for this discrepancy between BQB’s income and its operational costs may be due to the maximum allocation of zakat fund allowable to the management as governed by and stated in the Qur’an (QS 9:60). Zakat can only be distributed to eight categories of recipients, including zakat management. Allocations to zakat management of up to one eighth of the funds (i.e., 12.5%) take first priority as a form of compensation for management’s efforts in managing zakat. The balance of the funds is used to cover all
operational expenses: *zakat* management, including salary and wages, overhead costs, and promotional costs. This balance is likely to be insufficient to cover all operational costs and may mean that the human resources budget will be severely constrained.

Figure 6.1 provides a breakdown of BQB’s operational cost components. In 2011, employee salary and wages and field transportation expenses constituted the largest cost component. High expenses incurred by fieldworkers ‘one-client-at-a-time’ visits to collect loan repayments and monitor clients' progress, make up a significant portion of the transportation costs component shown in Figure 6.1.

**Figure 6.1 BQB operational costs composition 2011**

Source: Financial reports of BQB 2011

Baitul Maal Muamalat Indonesia’s strategy to cover its operational costs requires participants to pay a compulsory group fee and to create profit-making entities. Participants are required to make three types of payment at every meeting: the weekly loan re-payment installment, the compulsory group fee (3000 rupiah or $0.45), and a small donation (e.g., 1000 rupiah, or $0.15). The compulsory group fee is used to cover future meeting operational costs. A BMMI staff member noted that *zakat* funds can only cover weekly meeting costs for one year, after which time, client groups are expected to cover weekly meeting costs from the compulsory group fee. Islamic microfinance scholars share the view that an administration fee on loans is allowable in Islam (Siddiqi,
As qard hassan does not charge any return, a loan administration fee can be used to cover some operational costs.

High operational costs present a challenge to the achievement of institutional sustainability as ICBM institutions need to cover the costs of providing close client supervision and program monitoring activities. A limited operating budget may mean that staff numbers, staff performance incentives, and client support programs may need to be cut. Such cuts are likely to impact adversely in some way on clients’ attempts to build successful microenterprises. The cuts may also impact on the outcomes of the institutions’ loan programs in that cut backs in monitoring services may see lower rates of loan repayment.

In responding to questions related to employees’ motivation to work in ICBM institutions, mentors interviewed revealed that their primary motivation to work with this type of financial institution was to serve their religion rather than to earn an income (BMB-3, 2011, BQB-2, 2011). The mentors claimed that they are not well compensated. From one staff member’s viewpoint: ‘The salary…is very sad, but I am happy to help others’ (BQB-2, 8 Dec 2012).

This statement may explain the high rate of staff turnover in many financial cooperatives in Indonesia. Sakai and Marijan (2008) assert that the problem of limited human resources is widely evident in Islamic financial cooperatives in Indonesia. They argue that the high staff turnover in Islamic financial cooperatives is due to lower salary rates compared to those offered in the commercial finance market sector. For many Indonesians, particularly those who reside outside the metropolitan area, government sector employment is regarded as the most secure and admirable type of employment, while working in the non-government sector, such as in a financial cooperative, is considered a stepping stone to employment with the government, or a government agency. Therefore, offering salaries at the market rate may be a way to recruit and retain staff in financial cooperatives in Indonesia.
6.3.6. Repayment rate

BMMI evaluates the performance of each client group at the end of their loan period. Well performing groups will be invited to take up a second round of financing. Group performance is evaluated on the basis of the loan repayment rate and weekly meeting attendance. The document analysis of BMMI reports suggests that approximately half of the participants in the first round go on to participate in a second round of financing. The data from Table 6.3 show that only 56% of the total loan financing distributed in 2009 was repaid; a figure that decreases to 20% of the total financing repaid in 2010. This study finding does not support the argument that loans disbursed in mosques will be sanctified such that the loans will be repaid on time.

Table 6.3. BMMI Repayment Rate

<table>
<thead>
<tr>
<th></th>
<th>Total financing (in Rupiah)</th>
<th>Total repayment (in Rupiah)</th>
<th>Repayment %</th>
<th>Non-performing financing %</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>6,101,367,487.54</td>
<td>3,421,889,029.01</td>
<td>56.08</td>
<td>43.92</td>
</tr>
<tr>
<td>2011</td>
<td>3,309,973,000.00</td>
<td>689,968,425.00</td>
<td>20.85</td>
<td>79.15</td>
</tr>
</tbody>
</table>

Source: BMMI reports 2011

In addition, through document analysis of BQB reports presented in Table 6.4, the study was able to review the performance of 496 BQB loans distributed in 2011. The data show that 58% of loans were repaid on time. The data also pointed to a relatively high percentage of non-performing loans, indicated at 22% of the total number of loans.

In response to the question related to low repayment rates, one of the fieldworker staff interviewed mentioned that there are not enough fieldworkers to monitor all the clients. In 2012, only approximately 15% of BQB’s total clients were supervised and monitored by mentors. One fieldworker staff related, ‘It is not non-performing, it do not perform well because we have never collected the repayment due to the lack of human resources’ (BQB-2, 2011). The fieldworker’s response supports the claim that the one of the major challenges facing ICBMs in achieving institutional sustainability is the lack of human...
resources. As noted previously, issues around the lack of human resources can often be put down to severe cuts to the institution’s operating budget.

Despite human resource-related challenges, one BQB fieldworker indicated that low loan repayment rates may also be due to public perceptions of zakat as social organizations that simply disperse charitable funding directly to those in dire need, without an expectation that this funding be repaid. Many of the public are of the view that these recipients should take out loans in a more formal commercial context.

Table 6.4. BQB Loan Performance in 2011

<table>
<thead>
<tr>
<th></th>
<th>Number of loans</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Well performing loan</td>
<td>287</td>
<td>58</td>
</tr>
<tr>
<td>Not so well performing</td>
<td>90</td>
<td>18</td>
</tr>
<tr>
<td>Non-performing</td>
<td>109</td>
<td>22</td>
</tr>
<tr>
<td>No data</td>
<td>10</td>
<td>2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>496</strong></td>
<td><strong>1</strong></td>
</tr>
</tbody>
</table>

Source: BQB financial reports 2011

6.3.7. Sharia compliance

The mandatory requirement for sharia compliance in the management of ICBM funds can be a crucial factor in attempts to achieve institutional sustainability. As discussed in Chapter Three, zakat funding is the most regulated type of Islamic charity. One of the more debatable issues in using zakat for productive economic activities is compliance with the concept of tamlik. The concept of tamlik is defined as the transfer of ownership of zakat from its donors to loan recipients; whereby the recipients have full authority to own and use zakat funds for their own purposes (Ahmed, 2004, Sarif and Kamri, 2009). The analysis of the institutional case studies identified that both BMMI and BQB, institutions primarily funded by zakat, have attempted to comply with the concept of tamlik. The findings also brought to light inherent complexities to comply with tamlik rulings within sharia law.
The first compliance issue relates to the use of zakat to distribute benevolent loans as start-up capital for micro-businesses. When zakat is given as a loan, the transfer of ownership of the funds does not take place as the client has to repay the loan. The microfinance model of BMMI utilizes zakat to provide revolving loans, which means that loans are never transferred to the borrower to be owned in any way, as might a tangible asset. The repaid loan funds are then used to finance loans to other beneficiaries. In that sense, these loans are described as revolving to other beneficiaries. Such loan-revolving schemes risk contradicting the concept of tamlik that stipulates that zakat funds are to be given to the poor as custodians.

One of BMMI’s strategies to accommodate the concept of tamlik is to establish financial cooperatives that are owned and managed by the poor. A management staff interviewee said that financial cooperatives provide an opportunity to return zakat funding in the form of repaid loan monies to the poor. This practice is also questionable as according to sharia law, the poor should have full authority to use their loan funds for their own purposes and interests (Ahmed, 2004, Sarif and Kamri, 2009). Consequently, BMMI needed to seek an agreement from the poor that repaid loan funds would be used to establish financial cooperatives.

The strategy of developing financial cooperatives also carries some limitations, specifically in relation to whether the poor have sufficient skills to manage these. On this issue, BMMI management staff interviewed explained that they would provide technical assistance for one year to support the smooth running of the cooperatives. However, according to some interviewees’, one year of technical assistance would not be sufficient as the development of the cooperatives is still sluggish, indicated by their low growth and high staff turnover (BMMI-1, 12 Dec 2012).

The second institution, BQB, has taken a different approach to comply with the concept of tamlik. BQB states that their financial product is basically a grant rather than a loan. An ordinary grant is supposed to provide one off assistance and is not expected to be repaid. The case is different with the BQB grant in that the grant is explained to clients as a form of qard hassan financing that has to be repaid within 10 months. One of the reasons management communicates an interpretation of the grants as a qard hassan loan...
is to emphasize the point that qard hassan funds are intended to empower the poor. By explaining that the grant is effectively a loan, management expects that grant recipients will work hard to generate sufficient income to repay “the loan”. BQB sees this as an effort to educate the poor to be responsible with their grant funds.

Similarly, BMMI claim that its program provides a benevolent loan, not strictly understood as a conventional loan. The case study institutions explained that that repayment of benevolent loans is actually not necessary as zakat is used to fund these. In practice, both BQB and BMMI require clients to repay the ‘grants’ and ‘benevolent’ loans. BQB sends fieldworkers to directly collect repayments from the client’s house, while BMMI collects loan repayments during the weekly meetings. In addition, the performance of BQB’s staff and fieldworkers is also evaluated based on their ability to collect repayments. Such loan payment collection practices create significant operational inefficiencies as the collection process incurs high operating costs. Interestingly, from the fieldworkers’ perspective, they prefer to use the term ‘loan’ rather than ‘grant’ in order to align with the terminology and intent of the programs’ success indicators. As one mentor commented: ‘I’ve never said it was a grant since I have a responsibility to collect it back. My work performance is evaluated based on how many clients’ business survived? How many clients have repaid the loan? How many clients have saving account with BQB?’ (BQB-2, 8 Dec 2012).

This comment is interesting as it points out some of the complexities inherent in what might be understood as unconventional loan programs and policies. The mentors’ performance is evaluated on how well the client is managing their loan repayments, that is, how the loan is performing. This notion of performance seems somewhat contradictory given management has stated that it does not expect participants to repay their loans. Therefore, it is argued that if the institution is highly dependent on zakat funding, the concept of tamlik is represents one of the most challenging sharia rules to comply with.

The case is slightly different for BMB. Unlike BQB and BMMI that draw only on zakat funds for qard hassan loans, the management of BMB said that only a small amount of zakat is used to finance its loan programs. Irrespective of the amount of zakat funding
provided, the compliance rule remains. To comply with sharia law, BMB has to ensure that funds from different funding sources are kept in separate depositories. *Zakat* funds are intended to be used only to support direct charity programs such as natural disaster assistance, the provision of clean water supplies and mass education. In addition, the funds from *shadaqa* sources are expected to be directed towards empowerment programs through *qard hassan* and other Islamic funding schemes. These funding allocation strategies aim to ensure compliance with sharia law (Obaidullah, 2008).

As noted in Chapter Three, *zakat* funds must be disbursed in the same year of collection and are intended to provide short-term assistance to the poor. This relatively short time frame for the disbursement of microfinance funds presents a challenge for institutions. From the analysis of benevolent loan characteristics (see section 6.2.1), it was found that BMMI’s and BMB’s *qard hassan* programs are run over a one to two year period. By contrast, BQB’s *qard hassan* loans programs are run over one year. This ‘time-limit’ related rule may severely hinder the achievement of program objectives and consequently weaken their capability to address poverty (Gonzalez-Vega, 1998). Studies focused on the impacts and outcomes of microfinance programs are generally conducted using a pre- and post-program study design: at the beginning of the program, as the baseline period and after a specific intervention period of at least three years (Morduch and Haley, 2002). These study findings suggest that the rule requiring *zakat* funds to be used within a year of their donation may significantly constrain the potential of targeted intervention programs to deliver productive outcomes.

To sum up, the study findings identified several factors that may impact on ICBM institutional sustainability in either favorable or unfavorable ways. Overall, the case study ICBM institutions at the center of this study demonstrates key internal strengths in their capability to manage donated funds, create innovative program strategies, and make transparent their accountability mechanisms. Issues around the management of loan repayment rates, staffing, limited operating budgets, and meeting sharia compliance were identified as possible internal weaknesses that may jeopardize institutional sustainability. Table 6.5 summarizes these identified key success factors and key challenges that become apparent from the interview data analyses.
Table 6.5. Strengths and weaknesses impacting on institutional sustainability

<table>
<thead>
<tr>
<th>Strengths</th>
<th>Weaknesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>BMMI</td>
<td></td>
</tr>
<tr>
<td>- Increasing amounts of charitable funds collected</td>
<td>- Highly dependency on zakat sources</td>
</tr>
<tr>
<td>- The development of a profit entity to reduce dependency on charitable funds</td>
<td>- Limited volunteerism</td>
</tr>
<tr>
<td>- Support from local religious leaders in utilizing local mosques as central program venues</td>
<td>- High operational costs</td>
</tr>
<tr>
<td>- Accountability measures: Public Internet access to audited financial statements</td>
<td>- Complexity to comply with the concept of <em>tamlik</em></td>
</tr>
<tr>
<td></td>
<td>- Inherent complexities within <em>tamlik</em> and sharia law compliance practices</td>
</tr>
<tr>
<td></td>
<td>- Low loan repayment rate</td>
</tr>
<tr>
<td>BQB</td>
<td></td>
</tr>
<tr>
<td>- Increasing amount of charitable funds collected</td>
<td>- Highly dependency on zakat sources</td>
</tr>
<tr>
<td>- Innovative fundraising schemes</td>
<td>- Limited volunteerism</td>
</tr>
<tr>
<td>- Accountability measures: Public Internet access to audited financial statements.</td>
<td>- Limited support from the community</td>
</tr>
<tr>
<td></td>
<td>- Operational costs higher than revenue</td>
</tr>
<tr>
<td></td>
<td>- Inherent complexities within <em>tamlik</em> and sharia law compliance practices</td>
</tr>
<tr>
<td></td>
<td>- Low loan repayment rate</td>
</tr>
<tr>
<td>BMB</td>
<td></td>
</tr>
<tr>
<td>- Increasing amount of charitable funds collected</td>
<td>- Limited volunteerism</td>
</tr>
<tr>
<td>- The ability to develop community partnerships and to obtain CSR funds</td>
<td>- Lack of accountability</td>
</tr>
<tr>
<td>- Program innovations</td>
<td>- Lack of a clear division of funds</td>
</tr>
<tr>
<td>- Community involvement in programs</td>
<td></td>
</tr>
</tbody>
</table>

Source: author’s analysis draw from the interviews and document analysis data

After identifying some of the factors that may impact either favorably or unfavorably on the achievement of institutional sustainability, the study explores possible relationships between these sustainability impact factors to better understand ICBM sustainability. As particular phenomena, such as institutional sustainability, cannot be attributed to any
single variable or factor, finding connections, or relationships between differing variables offers the possibility of turning up more meaningful research results that capture more rather than less about the particular phenomenon. Qualitative research can be designed to specifically explore relationships between variables that may turn out to shed light on causality and contribute to the development of a theory that can explain the real phenomenon (Merriam, 1988). The following discussion examines possible relationships between factors affecting sustainability.

6.4. Relationships between factors affecting ICBM sustainability

The data analysis presented in the previous section suggests that some of the factors identified in Table 6.5 are closely linked in that they seem to stem from a single factor or from an institutional decision. Taking the sustainability-related study findings (see Table 6.5) together with insights from the study’s literature review, the following discussion is focused on particular internal sustainability key success factors and key challenges faced by ICBM institutions.

The findings indicated that each case study institution demonstrated its capability to enhance its funding collections in 2011 and 2012. This thesis contends that the increasing amounts of funds collected by ICBMs institutions can be correlated with the success of the ICBM institutions in adopting innovative fundraising strategies, in promoting their innovative empowerment programs and enforcing accountability measures. These findings have some support from the literature in their suggestion that institutions may be successful in their efforts to achieve sustainability if they have the capability to generate sufficient funding, innovate and make transparent their accountability measures (McDonald, 2007, Sontag-Padilla et al., 2012, Courney, 2002, Yetman and Yetman, 2004).

In addition, Ledgerwood (1998) points out that high operational costs and low loan repayment rates contribute to high institutional dropout rates in the microfinance industry. The case study interview findings as previously discussed in relation to high operational costs and low repayment rates concur with Ledgerwood’s study. A large proportion of the operational costs identified in the ICBM case studies was found to be
due to high human resource costs. These costs could be significantly reduced and sustainability enhanced if institutions could attract greater community support and encourage more extensive volunteerism (Khan 2011).

The case study analysis found that for BQB and BMMI, community support and volunteerism are limited. The possible reason why BQB and BMMI attract only limited community support may be due to the long distances between the organizations and their clients. Both BQB and BMMI have national coverage and are managed from their Jakarta main office. By contrast, as a result of being a local organization, BMB enjoys significant community support in various forms. This analysis appears to support an assertion that local ICBMs that receive greater community support are able to attract diverse funding sources and higher rates of volunteerism. As such, institutions can reduce operational costs and create more flexible ways of achieving institutional sustainability. These relationships are depicted in Figure 6.2.

Figure 6.2. Relationships between locality, community supports and institutional sustainability
mandated obligation of ICBM institutions to comply with sharia law specifically in relation to asset transfer (i.e., *tamlik*), and the notion that loan repayments cannot be enforced. From the institutions’ perspective, a *zakat*-funded loan program is basically understood as a grant program, in which repayment of the loan is not the main objective of the program, but loan repayments are encouraged as a way to motivate clients to succeed in their microenterprises. Although BMMI has established a mechanism to enhance loan repayment rates, the case study analysis demonstrated that this mechanism is rarely enforced. Consequently, the overall repayment rate for these ICBM institutions is low. Additionally, the need to comply with Sharia law means that the maximum amount of the funding budget allowed for overall operational costs is only 12.5%. This relatively low operational budget may limit the capability of institutions to recruit the staff needed to collect loan repayments and to offer competitive salary rates.

The second rationale as to why rates of loan repayment are low in *zakat*-funded institutions can be explained by a general public perception that *zakat*-funded loans are understood to be direct grants that are not required to be repaid. This understanding presents a challenge for fieldworkers in their task to collect loan repayments. The relationships between dependency on *zakat* funding and low repayment rates are depicted in Figure 6.3.
6.5. **ICBM regulations and government support**

Currently, the ICBM sector in Indonesia operates in an unregulated environment as ICBM providers are not regulated under Indonesian microfinance law 1/2013 (UU Lembaga Keuangan Mikro no. 1/2013). This means that ICBM institutions do not have to provide institutional reports to any government authority.

The regulation of microfinance institutions can strengthen compliance measures, improve accountability and more importantly, guarantee the security of financial transactions. As the law excludes ICBM institutions, their savings products are not government-guaranteed if the institution becomes insolvent through bankruptcy. By extension, this means that without some form of government regulation, institutions may find it increasingly difficult to attract savings deposits from the public and to expand existing funding sources.

The *zakat* management law 23/2011 (UU Pengelolaan *Zakat* 23/2011) sets out the regulations for the management of *zakat* charitable funds. Although this law does not...
provide a clear statement about how these funds are to be distributed for microfinance purposes, the law indicates that zakat can be distributed for both productive and consumptive purposes. The specific regulation relating to productive uses of zakat, Article 27 (2), states that productive zakat can only be given after funds recipients’ basic needs are met. A further article states that operating procedures for productive zakat are covered by specific government regulations (Peraturan Pemerintah). However, two years after the implementation of zakat law, the use of zakat funds for productive purposes has yet to be recognized within the microfinance regulatory framework. In practice, as a consequence of the lack of formal regulation of productive zakat, ICBM practices are carefully scrutinized within institutions’ sharia committees. The implementation of more formal microfinance regulations might lead to the standardization of practices within ICBM institutions in Indonesia.

Within Indonesian sharia law, as approved by the Indonesian Islamic Jurist organization (Majelis Ulama Indonesia/MUI), productive zakat is regulated by MUI’s fatwa that allows zakat to be distributed in productive ways. This fatwa stipulates a mandatory obligation that the basic needs of the poor must be fulfilled, before zakat is distributed for productive economic activity. This fatwa does not provide specific guidance on the implementation of the use of zakat in microfinance. Given the widespread nature of poverty in Indonesia, it has been suggested by this fatwa that zakat funds should firstly be directed towards poverty alleviation measures before it is used for other microfinance purposes. This is one of the main challenges facing ICBMs in developing alternative models that can provide sustainable development initiatives without denying the inherent intended purposes of zakat.

This study has identified that ICBM practices are excluded from Indonesia’s microfinance institution sector’s regulatory environment. Since these ICBM institutions provide financial services and mobilize savings from society, some form of regulatory framework is considered essential to provide products and services for financially needy clients and to ensure a high standard of governance of the ICBM sector. Interestingly, the Indonesian government has stated that this voluntary sector should provide valuable capital injections into the operations of micro enterprises, a service that has not to date been made available by formal financial institutions (MKUMK 2012). From this, it is can
be argued that there is an imperative to develop and implement government regulations that can strengthen the operations and protect the viability of the ICBM sector to maximize the role of this sector in the society.

Overall, by adopting the institutional sustainability concept, this study can draw four findings on ICBM sustainability. Firstly, the selected case study ICBM institutions in this study have successfully generated sufficient funding for their programs through innovative initiatives intended to expand their fundraising operations and to enhance their program offerings. Accountability management strategies were also the focus of the institutions’ attempts to generate sufficient funding. Secondly, the study found that local ICBMs, in this case BMB, demonstrated greater capability in securing community support in order to reduce overall operational costs and to generate more diversified funding sources. These capabilities are understood to underpin this ICBM institution’s sustainability. Thirdly, the study found that the case study ICBM institutions BMMI and BQB are highly dependent on zakat funding sources and face greater sharia compliance challenges in relation to tamlik guidelines and in managing public perceptions of zakat as ‘free money’. These sharia compliance and public perception challenges are likely to impact adversely on the achievement of institutional sustainability. The fourth finding pointed out the issue of unregulated ICBM operating environments. In this study it was found that the case ICBMs are not adequately supported by formal regulations particularly in relation to guiding management operations and overseeing governance issues.

6.6. Conclusion

ICBM is a type of microfinance provision that draws on Islamic charity to provide financial and non-financial services for the country’s poor who are identified as zakat recipients. The services offered by ICBM institutions include interest-free loan packages, mentoring programs, voluntary savings products, continuation programs and non-financial services, with an overall aim to empower and significantly enhance the wellbeing of zakat recipients.
The institutions’ capability to provide continuous microfinance services to their clients is of central research interest in this study. To examine this issue, the study evaluated the institutional sustainability of three ICBMs provider in Indonesia using a case study approach. This study has identified some of the case study institutions’ internal key success factors and key structural challenges that may impact on the achievement of institutional sustainability. By establishing the relationship between these factors and challenges, this chapter reported four findings on ICBM institutional sustainability.

The next chapter will evaluate a further indicator of ICBM success: the extent to which ICBM institutions have the capability to achieve broad and deep outreach in order to optimize the benefits offered by ICBM poverty alleviation programs. This success indicator represents the second key ICBM objective, first introduced in Chapter Three.
Chapter 7

Examining the outreach of Islamic charity based microfinance in Indonesia

7.1. Introduction

This chapter presents findings from an analysis of survey questionnaire and interview data focused on the study’s case institutions’ outreach and includes further information on client’s demographic profiles and poverty levels. Outreach is one of microfinance performance indicators that is used to indicate the extent to which institutions can locate, include and deliver their products and services to the impoverished. Outreach becomes an important issue since many microfinance providers are criticized for focusing more on wealthier clients at the exclusion of the poor in order to minimize the risk of loan defaults that may then threaten financial sustainability. The survey questionnaire and interview responses to outreach related questions were analyzed using descriptive analysis, poverty analysis and the application of binomial logit modeling.

This chapter is structured as follows: Section 7.2 discusses institutional client coverage, including targeting and communication strategies; Section 7.3 presents the study’s survey findings including those related to clients’ demographic characteristics, levels of income and expenditure, participation in commercial financial institutions, and issues around clients’ participation in social assistance programs. Section 7.4 examines clients’ poverty levels using as an indicator, the average loan per borrower proxy and the national poverty line indicator on food expenditure. Section 7.5 examines factors influencing client selection using the application of a binomial logit model. Section 7.6 presents the overall study findings and the last section concludes the discussion.
7.2. Institutional client coverage and the target market

From the survey and interview data, it appears that the case study institutions provide services at different levels of client coverage. Both BMMI and BQB, as nationally-covered zakat organizations, provide services across most parts of Indonesia. BMMI’s microfinance program is a mosque based program delivered through 185 mosques, in 28 cities and 21 provinces. This microfinance mosque based program includes 4,697 participants with total revolving funds of $US6.46 million and in 2012, employed 202 mentors. By contrast, BQB’s 2011 microfinance programs were restricted to several areas of Jakarta, Depok, Tangerang, Bekasi and small areas in West and Central Java. The third institution, BMB is a local institution in Yogjakarta, in the center of Java Island, well-known as a center of Javanese culture. The institution has branches in 10 of Yogjakarta’s 14 sub-districts and in some sub-districts in Sleman and Bantul. Its microfinance program started in 1994, with over 500 clients participating each year in the various programs offered by BMB institutions.

In this case study, two major differences between the two case zakat funded ICBM institutions BMMI and BQB, and BMB emerged. While BMB has nearly two decades of experience in delivering ICBM programs, the development of zakat funded ICBMs over the past five years is a relatively new phenomenon. Rapid growth in the Islamic charity sector has seen a significant expansion in the numbers of zakat-funded ICBM institutions. Another major difference between BMMI and BQB, and BMB, is the extent of their outreach coverage that influences the ability of the institution to reach specific clients. Zakat funded organizations that focus on wider national coverage, may face logistical challenges in the communication and monitoring of its programs compared to the BMB model that focuses on the immediate local area. The questions ‘who are is the target clients?’, ‘how do institutions reach them?’, and ‘how are the programs communicated and implemented?’ guide the next section’s discussion.

7.2.1. The target clients and the targeting strategy

The case study institutions shared a similar understanding that their outreach programs are intended to provide financial services for the mustabik, or those who are eligible zakat
recipients. Moreover, the programs are designed specifically for the first two categories of zakat recipient: the poor and the needy.

Prospective ICBM clients need to meet certain eligibility criteria to receive microfinance funding. Both BQB and BMB use an assessment of clients’ poverty levels as one of its key criteria. BQB states that prospective clients must live on a maximum income per capita of $US2 per day. BMB does not set a threshold level on income; rather they use the term *dhuafa* to identify the very poor in society in Indonesia. All case study institutions confirmed that they did not use gender as a criterion for determining clients’ eligibility. The study data indicates that there is a large proportion of female clients who have participated, or who are currently participating in the institutions’ program. The survey data shows that 90% of BMB’s clients are women. The management of BMB reveals that within Yogjakarta’s low income population, women generate the major source of family income. One of the management staff notes that women work harder for the family, thus they are more likely to participate in the program rather than men (BMB-1, 2011).

In comparison to BQB and BMB, BMMI expects prospective clients to meet more specific criteria. In the first instance, prospective BMMI clients must be active participants in their mosque and be already engaged in an existing microfinance enterprise. The clients’ benevolent loan performance is not only evaluated on the basis of timely repayments, but also on their participation in mosque activities. The eligibility criteria for prospective BQB and BMB clients are more flexible compared to those of BMMI. The BMMI’s specific selection requirements that prospective clients must actively participate in mosques and must have existing business may unintentionally exclude poorer members of the community.

Along with differences in eligibility criteria between the case study institutions, there are also differences in the client selection process. BQB is the only institution that has a clear selection process. BQB’s application process begins with a survey of zakat recipients. In this process, clients who live in the sub-district Jabodetabek (Jakarta, Bogor, Depok, Tangerang and Bekasi) are required to come to the main office of BQB to present their business proposal with their latest electricity bills and a letter from the
village government confirming their financial hardship. Fieldworkers then visit clients in their homes to verify the clients’ living circumstances. For clients who live in other cities, the application process is more flexible with verification processes conducted by telephone.

By contrast, BMB and BMMI use personal recommendations to select their clients. In this process, BMB identifies potential problems related to the availability of social assistance programs in each of Yogjakarta’s sub-district levels. This information is then used to select locations that have local business potential, and that have to date, received little in the way of government-funded social interventions. For example, BMB located an area where the local residents are highly experienced in quality pottery manufacture. As the residents do not have access to funding to establish their own independent pottery enterprises, they generate income through their employment with a pottery company that pays minimal salary rates. After identifying a suitable location, BMB will contact local leaders to gather information about prospective clients and seek recommendations in relation to who may be eligible to receive microfinance funding.

Similarly, BMMI rely on recommendations from the local branches of Bank Muamalat to select their clients. Bank Muamalat also takes responsibility for selecting a local mosque to be used as a venue for program meetings and loans management activities. Bank Muamalat usually develops an affiliation with local religious leaders and local microfinance institutions to locate prospective clients.

Interestingly, the interviews with BMMI and BQB management staff and fieldworkers revealed that the process of locating clients is not that straightforward. A BQB fieldworker notes that in Jakarta, it is difficult to find clients who were really poor and who at the same time meet the institution’s eligibility criteria. The fieldworkers interviewed related that they are more flexible in choosing clients:

‘The problem is not just poverty, sometime people have unexpected problems such as bankruptcy, loss the job and so on. When I thought that this fund with lessen their problem and when I see they have a potency to grow, I will give them the grant’ (BQB-2, 2011).

Similarly, BMMI management staff identified inherent challenges in their attempts to design programs that might attract potential clients. Given the high target set to
distribute the funds within a given timeframe, BMMI currently does not expect prospective clients to meet specific poverty-related eligibility criteria, such as living under $US2 a day. The management is aware that this expectation may limit the programs’ outreach to the poorest of the poor as the main target of the institution.

As prospective clients may live in rural areas with limited means of communication, institutions need to pay particular attention to ways they can effectively communicate the purpose, content, availability and eligibility criteria of their microfinance programs. The data from the management staff interviews demonstrates that program communication strategies selected by each of the case study institutions vary. All of the case institutions use company websites to communicate their programs and services and to make press releases and company reports publically available. To increase public awareness of its programs, BQB regularly advertises these in the national newspaper, Republika. In addition, direct promotional strategies such as word of mouth are also used intensively. The staff of BAZNAS, as a main ICBM institution, actively promote BQB’s programs and recommend that prospective clients apply for a qard hassan loan from BQB when they require funds to establish their own micro enterprises.

As subsidiaries of commercial financial institutions, BMB and BMMI communicate their programs primarily via their main institutions, BMT Beringharjo and Bank Muamalat bank branches. Program information is also communicated through written media as well as through direct promotion by customer service staff. In addition, BMB also actively promote their programs at the village community and institutional level. The institution’s social functions, baitul maal, can provide opportunities to promote the programs to all stakeholders. For example, a village mass mentoring program organized by clients is regularly conducted to celebrate BMB’s anniversary. This particular program promotional strategy has the potential to increase society’s awareness of BMB’s programs and introduces clients, as BMB ambassadors to society. A summary of each case institution’s key outreach indicators, ‘outreach coverage’, ‘client eligibility criteria’ and ‘communication strategies’, is presented in Table 7.1
7.3. Client and non-client characteristics: the survey findings

The study identified the profile of the case study ICBM’s clients and compared this to the profile of non-clients identified through their responses to the survey questionnaires across several variables such as demographic characteristics, income and expenditure information, participation in commercial microfinance programs, clients’ non-financial-related problems, and the receipt, or not of other social assistance. As discussed in Chapter Three, the relevant hypothesis here is that the ICBM institutions will select the more financially vulnerable clients.
7.3.1 The clients’ and non-clients’ demographic profile

The survey questionnaire was taken by 4 groups of respondents: one for each of the case study institutions (3 groups, 154 participants) and one group of non-clients (82 participants). Overall, most respondents were older than 45 years had graduated from primary school, and were members of small family households headed by men. Notably, BQB’s clients were significantly older than the non-client group. By contrast, the age difference between BMMI’s and BMB’s clients and the non-client group is not statistically significant.

In relation to clients’ formal education levels, BMMI and BQB’s clients had completed their formal schooling (Years 7.8 and 7.5 years respectively). This finding indicates that these particular clients have very limited education and did not complete Indonesia’s compulsory nine-year education period. Clients were also found to have experienced fewer years of formal education compared to the non-client group. In contrast, BMB’s clients remained in the formal education system for a longer period compared to the clients’ of BMMI and BQB. The overall data points out that differences in the education levels of clients and non-clients are not statistically significant.

On family size, the ICBM clients lived in small family units with two or three children. In particular, BQB and BMB clients lived in significantly larger sized family units compared to those of the non-client group. In contrast, BMMI’s clients and non-clients live in similarly sized family units.

In relation to the gender of the head of client and non-client households, in all groups this role was taken predominantly by the male. Particularly, there are 27% of BQB’s female clients and 17% of BMMI’s female clients who play a role as the head of the family. The study also found that there were more female as head of the family in BQB than that of the non-client group. For clients who lived in Yogjakarta, around 8% of families have female as the household head. These findings suggest that there is a strong patriarchal culture shaping community life in this part of Indonesia. The study also found that there are significantly fewer female playing the head of the family role in the BMB client group than that of the non-client group. This patriarchal culture may
influence the extent to which ICBM institutions can successfully reach women to the program. A summary of clients and non-clients’ profiles are presented in the Table 7.2.

Table 7.2. Demographic profiles of the case ICBM clients and non-clients

<table>
<thead>
<tr>
<th>Family characteristics</th>
<th>Jakarta</th>
<th>Yogyakarta</th>
<th>Jakarta</th>
<th>Yogyakarta</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>BMMI</td>
<td>BQB</td>
<td>Non Clients</td>
<td>BMB</td>
</tr>
<tr>
<td>Age of household head (years)</td>
<td>46.77</td>
<td>49.11**</td>
<td>45.6</td>
<td>47.36</td>
</tr>
<tr>
<td>Formal education Year level achieved (years)</td>
<td>7.8</td>
<td>7.48</td>
<td>8.23</td>
<td>9.04</td>
</tr>
<tr>
<td>Family size</td>
<td>4.3</td>
<td>4.75*</td>
<td>4.05</td>
<td>4.06**</td>
</tr>
<tr>
<td>Percentage of male household head (%)</td>
<td>83</td>
<td>73**</td>
<td>83</td>
<td>92**</td>
</tr>
<tr>
<td>Total</td>
<td>48</td>
<td>63</td>
<td>59</td>
<td>50</td>
</tr>
</tbody>
</table>

Source: survey questionnaires data, ** significant at 95% confidence level, * significant at 90% confidence level

Table 7.2 points out several important findings related to the demographic profile of the case study ICBM’s clients and the non-client group. Firstly, BMMI’s clients have a similar demographic profile to the non-client group. Secondly, BQB’s clients are significantly older, have fewer years of formal education, and have more women as the head of the family compared to the non-client group. The findings also pointed out the significantly larger family sizes and more men as the head of the family of BMB’s clients compared to the non-client group.

7.3.2. Clients’ and non-clients’ income and expenditure profiles

The study compared the annual per capita income and monthly per capita food expenditure of both clients and non-clients. The questionnaires asked respondents to provide information about their food expenditure over the previous one month. The researcher considered that participants would be able to readily recall one month’s stock of information particularly if requested close to the survey period. Respondents provided an estimate of the cost of their food intake by using a standardized measure of a unit of consumption, calculated on food costs at the time of the survey of common
food items in Indonesia: rice, meat/fish/tempe/tofu, vegetables, instant noodles, milk, sugar, coffee/tea, fruit, and cooking oil.

Overall, in Jakarta and Yogjakarta, clients spent less of their income on food than the non-client group; but the difference may not be statistically significant. It was found that only BQB’s clients spent statistically significantly less on food consumption compared to the non-client group.

### Table 7.3. Clients and non-clients monthly food expenditure

<table>
<thead>
<tr>
<th></th>
<th>Mean in rupiah ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>BMMI</td>
</tr>
<tr>
<td>Monthly per-capita expenditure</td>
<td>260,998.02 ($1.32)</td>
</tr>
</tbody>
</table>

Source: survey questionnaire data, ** Significance at 95% confidence level

In addition, the study also collected data on clients’ and non-clients sources of household income averaged over a 12 month period up to the time of the study to allow for seasonal fluctuations. Respondents were not asked to declare their initial income prior to joining their institution’s programs, as clients’ recall of this type of information may be unreliable. The survey data indicates that many of the case study ICBM clients were found to be running self-employed enterprises with some assistance from other family members. These enterprises were located mainly within the informal market sector and comprised street vendors and petty traders, selling convenient food, snacks, cigarettes, drinks, and daily food supplies, from small shops/stalls at the front of their houses, in market places, or other busy locations, or door-to-door. Using the study’s observational data, most of these enterprises require minimum skills, have low barriers to entry and operate in a very competitive environment. These types of enterprises are classified as ‘survival enterprises’ in that most, if not all returns are used to meet every day basic household consumption needs (ADB and BPS, 2011).
The survey data presented in Table 7.4 found that the annual per capita income of clients and non-clients was greater than the minimal World Bank standard of $US2 per day. In Jakarta, the study found that the average of clients’ per capita income levels is lower than that of the non-client group. By contrast, the average of clients’ per capita income levels in Yogjakarta is higher than that of the non-client group. This difference in the average per capita income levels between client and non-client groups only statistically significant for BQB clients.

Table 7.4. Clients’ income levels

<table>
<thead>
<tr>
<th>Variable</th>
<th>BMMI</th>
<th>BQB</th>
<th>Non-clients</th>
<th>BMB</th>
<th>Non-Clients</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Jakarta</td>
<td></td>
<td></td>
<td></td>
<td>Yogjakarta</td>
</tr>
<tr>
<td>Annual per capita</td>
<td></td>
<td></td>
<td></td>
<td>5,817,300</td>
<td>5,468,979</td>
</tr>
<tr>
<td>Income in Rupiah</td>
<td>7,667,395</td>
<td>5,990,063</td>
<td>8,555,788.18</td>
<td></td>
<td></td>
</tr>
<tr>
<td>($)</td>
<td>($1166)</td>
<td>($911)*</td>
<td>($884.7)</td>
<td></td>
<td>($831.7)</td>
</tr>
</tbody>
</table>

Source: survey questionnaire data, *significantly difference to the non-clients income at 90% confidence level

The survey data revealed that client and non-client incomes are generated from multiple sources. Along with running a single micro-enterprise, clients and non-clients may also engage in other productive activities such as undertaking paid labor in households and local industries. The survey data further show that for the majority of clients, the head of the family and their spouse both need to generate income in order to meet even the most minimal of household expenditure demands. The household income generated from the household head alone will not be sufficient to fulfill the daily expenditure demands of lower income level households. As such, other family members also need to find ways of generating income to support the family. Loans provided by the case ICBM institutions are frequently used as start-up capital to initiate home-based microenterprises as a second source of income.

The analysis of clients’ and non-clients’ responses to survey questions probing annual per capita income levels and monthly food expenditure threw light on four key findings. Firstly, BMMI’s and BMB’s clients’ monthly food expenditure is not significantly different to that of the non-client group. Secondly, BQB’s clients spend significantly less
on food compared to non-clients. Thirdly, the annual per capita income of BMMI’s and BMB’s clients is not significantly different to that of the non-client group. Lastly, the annual per capita income of BQB’s clients is significantly lower than that of the non-client group.

To sum up, the study was revealing in its findings that BQB appears to have selected clients who have both lower per capita income levels and monthly food expenditure levels than the non-client group; while BMMI and BMB seem to have selected clients who are at almost equal annual per capita income and monthly per capita food expenditure levels as non-clients. In other worlds, these findings indicate that BMMI and BMB fail to include the poorest of the poor in the program.

7.3.3. Clients’ participation in the commercial financial sector

The analyses of the loan and savings profile data were intended to sketch a larger picture of the clients’ participation in the commercial microfinance and other financial institutional sectors. An initial assumption of this study was that the clients’ participation in commercial financial institutions is limited due to their inability to meet commercial banking requirements (Zeller and Johannsen, 2006). Overall, the study findings indicated that the client’s participation in commercial saving is considerably high. However, participation in the commercial lending market in order to secure a commercial loan is minimal.

It seems from the data analyzed that case ICBM clients are active savers as almost half related that they have savings deposit accounts. Information about clients’ savings presented in Figure 7.1 shows that in Jakarta fewer clients owned savings accounts compared to the non-client groups. This situation was reversed in Yogyakarta where more clients owned saving accounts compared to the non-clients. Specifically, the data figures show that the percentage of BQB clients holding saving accounts is the lowest at 32% compared to 46% of BMMI’s clients and 55% of BMB’s clients.

In this study the percentage of clients with savings accounts is notably higher than that reported in a previous survey conducted by Benerjee and Duflo (2011). Their data
reveals that in Indonesia, of the rural and urban poor living below $US1 per day, only 8.6% of the rural poor and 11.9% of the urban poor operate their own savings accounts. Of the rural and urban poor living below $US2 per day, 13.5% of the rural poor and 21.1% of the urban poor operate their own savings accounts.

The survey data indicated that clients’ take a conservative approach to the management of their savings with cash savings preferred over savings in the form of fixed assets (100% of BMMI clients, 94% of BQB clients and 97% of BMB clients). Although all of the case ICBM clients’ incomes were considerably low, the practice of saving is common amongst the poor. For the majority of clients, the value of their savings is less than Rp. 1,000,000 ($152). The survey data shows that savings are generally used for a wide range of purposes: education, health services, business development, celebrating religious events, wedding, donations and loan repayments.

The study findings of the clients’ participation in the commercial financial sector indicate that significant numbers BMB’s and BMMI’s clients own saving accounts in commercial financial institutions. The survey data show 41% of BMB’s clients own savings accounts in financial cooperatives; while 22% have savings accounts with commercial banks. For BMMI, 38% of its clients save with commercial banks. These results are not surprising as both BMB and BMMI are affiliated with commercial financial institutions.

According to the interview data, the ownership of savings accounts by clients is actively supported by the case ICBM institutions’ expectation that clients will deposit a small amount of money at every group support meeting. BMMI and BMB run periodic group meetings at which their clients are required to pay a periodic loan installment and to make a voluntary savings deposit. Although saving is not compulsory for all clients, BMMI and BMB staffs encourage clients to save by teaching them the advantages of saving as a form of assets accumulation. In addition, according to the interview question responses related to the characteristics of savings practices, the high participation rate of BMMI clients in commercial banks is due to the obligation placed on clients to open Bank Muamalat saving accounts as a condition of the loan distribution process (BMMI-1, 2011). By contrast, BQB’s clients are more conservative than those of BMMI, BMB
and the non-clients. The majority of BQB’s clients (68%) prefer to keep their savings at home.

Figure 7.1. Clients and non-clients’ ownership of savings accounts

The survey also asked clients and non-clients about their participation in the commercial loans banking sector. The clients and non-clients provided information about the loan characteristics including the number of loans serviced, the amounts borrowed, the purpose of the loan, interest rate payments, and about the loan providers. The data show that most of the loans secured by the case ICBM clients are interest free and do not require any collateral. A significant percentage of BQB clients engage in multiple borrowing (46%). These clients’ first loans are generally interest free; while the second loan is obtained from various sources including family, neighbors and other sources such as local grocery shops that provide credit facilities to the poor. Clients’ second loans generally incur interest payments. These loans are used for meeting basic everyday consumption needs (i.e., food and clothing), and to manage daily cash needs.

The non-clients’ borrowing profiles are more varied in terms of loan sources and types, guarantees and purposes. The non-clients’ loans are mostly sourced from non-formal sectors such as family, neighbors, grocery shops, and from non-formal money lenders. Approximately half of the loans (43%) attracted interest payments. In the majority of cases, non-clients’ loans are used for consumption purposes and to provide working capital. This survey data indicated that non-clients’ participation in commercial loan products is also very limited.

Source: survey questionnaire data
The analysis of clients and non-clients responses to survey questions examining saving and loan profiles suggests two important findings. Firstly, the clients of the case study ICBMs are active savers and are shown to be active participants in the commercial savings. By contrast, the second finding shows that the majorities of ICBM’s clients only obtains interest-free loans from ICBMs and have limited participation in commercial loan products.

7.3.4. Clients’ and non-clients’ non-financial challenges

The survey asked clients and non-clients to identify some of the non-financial limitations they face in running their own microenterprises. The survey responses show that business related skills and health problems become the most common non-financial challenges faced by both clients and non-clients.

The analysis of clients and non-clients responses on ‘non-financial challenges’ questions show that 25% of BQB clients, 22% of BMMI clients and 37% of the BMB clients claim to have limited skills in running a microenterprise. For the non-client group, 24% and 6% of non-client respondents in Jakarta and Yogjakarta, respectively claim to have limited business skills. The non-client group seems to be more confident about their business-related skills and capability to run their own microenterprises. These findings suggest that the case study ICBM clients see themselves as having fewer business-related skills than the non-client group.

When clients and non-clients were asked to identify their health over the year prior to undertaking the survey, results found that the majority of clients and non-clients see themselves as being in good health. However, there are significant percentages of BQB clients (32%), the highest of all participant groups, who mentioned that they had experienced a serious health problem in the year prior. That BQB’s clients rated their health as low indicates that BQB program selected clients with more vulnerable health status.

In comparison to the client group, the data indicate that both the non-client-group participants in Jakarta and Yogjakarta rated their health status more highly than did the clients. The data from the survey points out that 32% of BQB’s clients, 22% of BMMI’s
clients and 12% of BMB’s clients experienced serious health problems in the previous year; while only 11% of non-clients in Jakarta and 6% of the non-clients in Yogyakarta reported serious health problems. The findings suggest that the case study ICBM clients may be more vulnerable than non-clients in their health status.

The analysis of clients’ and non-clients’ responses to survey questions investigating non-financial problems indicates that clients’ limited business skills and health concerns over the preceding year point to significant barriers that may limit the extent to which clients can take full advantage of ICBM institutional products, services and support programs. As such, these findings may usefully inform further research in relation to program design and objectives as discussed later in Chapters Eight and Nine.

7.3.5. Clients’ and non-clients’ participation in social assistance programs

One of the major priorities of the current Indonesian government is to reduce the poverty rate from 11.96 % in 2012 to 8% in 2014. To realize this target, the government allocated around $US30 billion to social assistance poverty alleviation programs designed to reach households assessed to be at below and just above the poverty line. Examples of these programs include the provision of rice for the poor (beras miskin), the implementation of direct cash transfers (bantuan langsung tunai), and free health services (jaminan kesehatan masyarakat). Additional to this government assistance, there are various social assistance programs aimed at poverty alleviation, such as company social responsibility (CSR) programs, and religious and privately donated charitable funds.

The survey asked clients and non-clients to provide information about various social assistance programs and services they had taken advantage of. Social assistance is classified into three categories: social assistance from religious charities, including zakat, infaq and shadaqa, social assistance from the government as earlier described, and other social assistance programs, including access to scholarships and private donation.

The basic assumption underlying questions related to clients’ and non-clients participation in social assistance programs is that both clients and non-clients are likely to be targeted by the government and invited to take up various poverty alleviation assistance programs. On the basis of the study’s preposition described in Chapter One,
the ICBM clients are more likely to be targeted by various assistance programs than non-clients. Overall, the survey data demonstrate that less than 50% of both client and non-client groups participated in social assistance programs. This data suggest that both client and non-client participation in various social assistance programs is likely to be limited due to inadequate government funding for social programs and services, purposefully designed to reach the poor.

Overall, the descriptive analysis of clients and non-clients’ demographic profiles, income and expenditure information, participation in commercial microfinance programs, non-financial-related problems such as health status, and the receipt, or not of other social assistance indicate that the BMMI’s and BMB’s ICBM programs do not target services to specific client profiles. In contrast, BQB’s clients appear to have different profiles than non-clients for most of variables identified above. The next discussion steps up to analyze the poverty levels of clients and non-clients.

7.4. Examining the poverty level of the clients and non-clients

To determine the poverty level of the clients and non-clients the study utilized three different measures: comparisons between the average loan balance per borrower of ICBM and that of the other types of microfinance providers in Indonesia, the use of the earlier discussed Indonesian poverty line measure, and the application of a statistical binomial logit model constructed to estimate probability of respondents selected as a client in case ICBM program.

7.4.1. Comparisons between the average loan balance per borrower of microfinance providers in Indonesia

This section compares the average loan balance per borrower of ICBM to that of other types of providers of microfinance in Indonesia. Table 7.5 presents the average loan balance per borrowers of four types of microfinance providers in Indonesia. The data indicate that ICBM institutions have the lowest average loan balance per borrower compared to the four other types of microfinance institutions at 2.5% of the 2011 national GNP. Notably, this balance is also lower than the average loan balance per
borrower within the non-religious NGO microfinance sector. This average loan balance per borrower indicator suggests that the ICBM institutions target prospective clients at lower poverty levels compared to other microfinance providers.

Table 7.5. Islamic microfinance providers in Indonesia: outreach indicators

<table>
<thead>
<tr>
<th>Microfinance institutions</th>
<th>Number of Institutions</th>
<th>Average loan per borrower (Rupiah)</th>
<th>Average loan per borrower ($)</th>
<th>Average loan per borrower/ GNI per capita (%)</th>
<th>Number of active borrowers</th>
</tr>
</thead>
<tbody>
<tr>
<td>ICBM</td>
<td>3</td>
<td>668,064.94</td>
<td>101.61</td>
<td>2.52</td>
<td>6,258</td>
</tr>
<tr>
<td>NGO</td>
<td>2</td>
<td>717,540.00</td>
<td>109.13</td>
<td>2.71</td>
<td>310,607</td>
</tr>
<tr>
<td>Credit Unions/Cooperatives</td>
<td>4</td>
<td>1,289,260.00</td>
<td>196.09</td>
<td>4.87</td>
<td>74,555</td>
</tr>
<tr>
<td>Rural Banks</td>
<td>8</td>
<td>11,686,848.00</td>
<td>1,777.47</td>
<td>44.17</td>
<td>71,485</td>
</tr>
</tbody>
</table>

Source: Document analysis of microfinance institution indicators published by The Mix Market (2011) and survey data

The tabled data also suggests that the NGO microfinance sector has the largest active client base with around 310,607 clients in 2011. This sector also indicates a lower average loan amount per borrower compared to the more regulated microfinance institutions such as cooperatives and rural banks. In contrast, rural banks indicate the highest average loan amount per borrower and serve the fewest clients at 71,585. Data presented in Table 7.5 are comparable with those reported in a 2000 study conducted by Bank Indonesia and GTZ of the pyramid structure characteristic of Indonesia’s microfinance institutions. This pyramid structure shows that the majority of microfinance clients are served by informal and semi-formal institutions, with fewer numbers served by formal microfinance institutions (Nugroho, 2010). Although Table 7.5 shows that ICBM targets clients at the lowest poverty level compared to other providers, this data only provides a glimpse of the bigger picture of poverty in Indonesia. The next section’s discussion thus extends the analysis of ICBM clients’ and non-clients poverty level as assessed by the national poverty line threshold.
7.4.2. Evaluation of clients’ and non-clients poverty levels using the national food expenditure poverty line

The second approach to examining clients’ and non-clients’ poverty level is by comparing respondents’ food expenditure to the national food expenditure poverty line. The analysis presented here is utilized two benchmarks: the national food expenditure poverty line set at 187,194 rupiah per month ($0.95 per day), and a ceiling benchmark set at $2. This ceiling benchmark is generally used to assess vulnerability to poverty circumstances.

Using the first benchmark, the study findings indicated that a significant percentage of the client and non-client groups live above the poverty line. This finding also indicated that many clients and non-clients spend more on food than the minimal national food expenditure poverty line benchmark in Indonesia. This finding supports BMMI staff’s and BQB’s fieldworkers’ assertions that finding the most eligible prospective clients to participate in the program is not easy (BQB-2, 2011). When clients’ food expenditure data is compared to that of the non-clients, it was found that the number of non-clients living above the national food expenditure poverty line was higher than that of the clients. This data may indicate that the case study ICBMs have attempted to reach out to more financially vulnerable households in their programs.

To evaluate the vulnerability of the participating clients and non-clients to poverty, the higher benchmark of $2 was utilized. The data generated from survey questions related to daily food expenditure show that the majority of clients and non-clients live below the poverty line. Additionally, the number of clients and non-clients living above the $2 per day benchmark is significantly fewer than the number of clients and non-clients living above the $0.95 per day benchmark. This particular finding suggests that some clients live marginally above the poverty line and as such, are highly vulnerable to falling into poverty conditions. This observation supports the previous 2011 World Bank study findings that 50% of Indonesian’s poor in the current year were not identified as poor in previous years. These poor households are characterized by income instability and high vulnerability to falling into poverty conditions. It is common for this sector of the
population to move in and out of poverty, thus making the implementation of social assistance programs and services an imperative in order to protect society’s poor from income uncertainty and risk of deeper poverty.

Table 7.6. Poverty level of the clients and non-clients

<table>
<thead>
<tr>
<th></th>
<th>Clients above the poverty line (%)</th>
<th>$0.95/day</th>
<th>$2/day</th>
</tr>
</thead>
<tbody>
<tr>
<td>BMMI Clients Jakarta</td>
<td>71</td>
<td>21</td>
<td></td>
</tr>
<tr>
<td>BQB Clients Jakarta</td>
<td>69</td>
<td>6</td>
<td></td>
</tr>
<tr>
<td>Non-Client Jakarta</td>
<td>78</td>
<td>31</td>
<td></td>
</tr>
<tr>
<td>BMB Client Yogjakarta</td>
<td>40</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>Non-Clients Yogjakarta</td>
<td>55</td>
<td>6</td>
<td></td>
</tr>
</tbody>
</table>

Source: survey questionnaires data

7.5. Client selection and determinant factors: the application of a binomial logit model

The previous findings show that although the case study ICBMs selected vulnerable marginally poor as clients, the institutions may have unintentionally excluded the poor and the poorest. The focus of this section’s discussion is to explicate the application of a binomial logit model to estimate whether clients and non-clients have significantly different profiles. Using several explanatory variables, a binomial logit model is able to estimate the probability of a respondent being selected as a client of ICBMs relative to not being selected. The findings from the application of the model are presented in the following subsections.
7.5.1. The probability of being selected as a BMMI client: the application of a binomial logit model

In this application, the binomial logit model estimates the probability of a respondent being selected as a client of BMMI relative to not being selected using a range of explanatory variables including prospective client demographics, income and expenditure levels, business and health related problems and participation in social assistance programs. The dependent variable is the log \( \log(p/1-p) \), where \( p \) is a probability of being selected as a client of BMMI. The model estimation is:

\[
\log\left(\frac{p}{1-p}\right) = a + b_1(\text{age}) + b_2(\text{family size}) + b_3(\text{length of schooling}) + b_4(\text{gender as dummy}) + b_5(\text{annual per capita income}) + b_6(\text{monthly per capita expenditure}) + b_7(\text{business skills}) + b_8(\text{health problem as a dummy}) + b_9(\text{social assistance participation as a dummy}).
\]

Using a 95% of confidence level, the explanatory variables are statistically significant in relation to influencing the probability of the respondent being selected as a client of BMMI program if the p-value is less than 5%. The model estimation shows that the only variable that is statistically significant in influencing the probability of a respondent being selected as a client is their annual per capita income.

The estimated coefficient of survey respondents’ annual per capita income is 0.314; which means, given other variables are constant, that an increase in annual per capita income, will increase of dependent variable \( \log(p/1-p) \) by 0.314. By taking the exponential of that value, the probability of a respondent being selected as a client \( p \) is 57%. This means that an increase in income by one million rupiahs will increase the probability of the client being selected by BMMI by 57%. A summary of the model estimation is presented in the Table 7.7.
Table 7.7. The probability of respondents being selected as a BMMI client

<table>
<thead>
<tr>
<th>Poverty profile characteristics</th>
<th>Variables</th>
<th>Coefficients (p-value)</th>
<th>Probability (p)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Intercept</td>
<td>-1.369 (.524)</td>
<td></td>
</tr>
<tr>
<td>Demographic</td>
<td>Age of household head</td>
<td>-.033 (.203)</td>
<td>49.16</td>
</tr>
<tr>
<td></td>
<td>Family size</td>
<td>.303 (.160)</td>
<td>57.52</td>
</tr>
<tr>
<td></td>
<td>Length of schooling of H head</td>
<td>-.078 (.261)</td>
<td>48.05</td>
</tr>
<tr>
<td></td>
<td>Household head gender</td>
<td>-.068 (.924)</td>
<td>48.29</td>
</tr>
<tr>
<td>Income and expenditure</td>
<td>Annual per capita income (in million rupiah)</td>
<td>.314** (.003)</td>
<td>57.79</td>
</tr>
<tr>
<td></td>
<td>Monthly per capita expenditure (in million rupiah)</td>
<td>-.503 (.804)</td>
<td>37.69</td>
</tr>
<tr>
<td>Personal concern</td>
<td>Limited business skills</td>
<td>.437 (.178)</td>
<td>60.75</td>
</tr>
<tr>
<td></td>
<td>Serious health condition</td>
<td>-.307 (.608)</td>
<td>42.39</td>
</tr>
<tr>
<td>Participation in social assistance program</td>
<td>Any other assistance</td>
<td>-.409 (.527)</td>
<td>39.90</td>
</tr>
</tbody>
</table>

Source: SPSS estimation output, **significant at 95% of confidence level

The binomial logit model estimates that for BMMI, it’s selection criteria is solely influenced by income related information, at the exclusion of any other information. Interestingly, the higher the prospective client’s income level, the higher the probability of their being selected. The rationale behind this possible selection outcome is that BMMI specifically requires the prospective clients to have an existing business. This requirement may drive the institution to select a higher income level group in the program.

7.5.2. The probability of being selected as a BQB client: the application of a binomial logit model

In this application, the binomial logit model was used to estimate the probability of a survey respondent being selected as a client of BQB instead of not being selected given several explanatory variables. The model estimation is:
\[ \log \left( \frac{p}{1-p} \right) = a + b_1(\text{age}) + b_2(\text{family size}) + b_3(\text{length of schooling}) + b_4(\text{gender as dummy}) + b_5(\text{annual per capita income}) + b_6(\text{monthly per capita expenditure}) + b_7(\text{business skills}) + b_8(\text{health problem as a dummy}) + b_9(\text{social assistance participation as a dummy}). \] 

Using a 95% confidence level, three variables are likely to significantly influence the client selection: family size, annual per capita income, and indications of health issues. This binomial logit estimation result supports the study’s descriptive analysis of BQB’s client profiles; in comparison to other respondent groups, who are likely to be older, with a shorter formal education period and who are likely have experienced significant health concerns over the previous years.

The first significant variable in the model’s estimation of the probability of being selected as a BQB client is family size. The coefficient of which for BQB’s clients is 0.464; Given other variables are constant, an increase in family size will increase the dependent variable \{ \log \left( \frac{p}{1-p} \right) \} by 0.464 and as such will increase the probability of being selected as a BQB client by 61.4%. This estimated coefficient indicates that BQB prefers to select clients with larger families.

The second significant variable to take into account is annual per capita income. The coefficient of this variable is 0.255, which means that an increase in a prospective client’s income level by one million rupiah will likely increase the dependent variable \{ \log \left( \frac{p}{1-p} \right) \} by 0.255 and increase the probability of being selected by 56.34%. This finding is interesting as the previous descriptive analysis of client’s income level indicates that, on average, the income level BQB’s clients is significantly lower than that of the study’s non-client group. Further, through the application of the binomial logit model, the resultant statistical finding suggests that BQB prefers to select clients at higher income levels.

Looking to the third significant variable, the incidence of health concerns is specified as a dummy variable, where ‘1’ is assigned to any client who faced a serious health concern in the previous year and ‘0’ is assigned to any clients who did not face a serious health concern in the previous year. The modeled estimation shows that the coefficient of this variable is minus 1.298, meaning that if a client suffered a serious health condition in the
year prior to their responding to the study survey, the dependent variable $\{\log (p/1-p)\}$ will decrease by minus 1.298, or alternatively that the probability of being selected as a client who had suffered a serious health condition will increase by 21.45%. A summary of these estimated probabilities of being selected as a BQB client is shown at Table 7.8.

Table 7.8. The probability of respondents being selected as a BQB client

<table>
<thead>
<tr>
<th>Category of characteristics</th>
<th>Variables</th>
<th>Being selected as a clients of BQB relative to not being selected</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Coefficients (p-value)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intercept</td>
<td></td>
<td>-.440 (824)</td>
</tr>
<tr>
<td>Demographic characteristics</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Age of the Household Head</td>
<td></td>
<td>-.023 (.335)</td>
</tr>
<tr>
<td>Family size</td>
<td></td>
<td>.464 (.021)**</td>
</tr>
<tr>
<td>Length of schooling</td>
<td></td>
<td>-.052 (.419)</td>
</tr>
<tr>
<td>Household Head</td>
<td></td>
<td>-.715 (.260)</td>
</tr>
<tr>
<td>Gender of household head</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income and expenditure</td>
<td></td>
<td></td>
</tr>
<tr>
<td>characteristics</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annual per capita income</td>
<td></td>
<td>.255 (.011)**</td>
</tr>
<tr>
<td>(in million rupiah)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Monthly per capita expenditure</td>
<td></td>
<td>-.540 (.789)</td>
</tr>
<tr>
<td>(in million rupiah)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Problems characteristics</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Limited business skills</td>
<td></td>
<td>.211 (.489)</td>
</tr>
<tr>
<td>Health problem</td>
<td></td>
<td>-1.298 (.016)**</td>
</tr>
<tr>
<td>Social assistance participation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Any other assistance</td>
<td></td>
<td>.625 (.257)</td>
</tr>
</tbody>
</table>

Source: SPSS estimation output, **significant at 95% of confidence level
7.5.3. The probability of being selected as a BMB client: the application of a binomial logit model

This third application of the binomial logit model estimates the probability of a respondent being a client of BMB relative to not being a client using similar explanatory variables. The model estimation of BMB client selection is:

\[
\log \left( \frac{p}{1-p} \right) = a + b_1(\text{age}) + b_2(\text{family size}) + b_3(\text{length of schooling}) + b_4(\text{gender as dummy}) + b_5(\text{annual per capita income}) + b_6(\text{monthly per capita expenditure}) + b_7(\text{business skills}) + b_8(\text{health problem as a dummy}) + b_9(\text{social assistance participation as a dummy}).
\]

The modeled estimate identifies that at a 95% confidence level none of the study variables significantly influence selection of clients into BMB programs. When the confidence level is set at 90%, the modeled estimate shows that family size has played a part in estimating the probability of a respondent being selected relative to not being selected. The coefficient of family size is -0.433, which means that an increase in family size will reduce the independent variable \( \log \left( \frac{p}{1-p} \right) \) by 0.433 and increase the probability of being selected by 49%.

Overall, this modeled probability of selection also supports the descriptive analysis of client’s demographic profiles that indicates that BMB clients share a similar profile with the non-client groups in relation to the variables age, length of formal education, and gender. In other words, on the basis of the survey data, BMB does not appear to select financially vulnerable clients. A summary of these estimated probabilities of being selected as a BMB client is shown at Table 7.9.
Table 7.9. The probability of respondents being selected as a BMB client

<table>
<thead>
<tr>
<th>Category of characteristics</th>
<th>Variables</th>
<th>Being selected as a clients of BMB relative to not being selected</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Coefficients (p-value)</td>
</tr>
<tr>
<td></td>
<td>Intercept</td>
<td>3.327</td>
</tr>
<tr>
<td></td>
<td>Age of the Household Head</td>
<td>.009 (.727)</td>
</tr>
<tr>
<td></td>
<td>Family size</td>
<td>-.433 (.898)</td>
</tr>
<tr>
<td></td>
<td>Length of schooling of household head</td>
<td>-.058 (.403)</td>
</tr>
<tr>
<td></td>
<td>Gender of household head</td>
<td>.098* (.064)</td>
</tr>
<tr>
<td>Demographic characteristics</td>
<td>Annual per capita income</td>
<td>-.138 (.155)</td>
</tr>
<tr>
<td></td>
<td>Monthly per capita expenditure</td>
<td>-.755 (.300)</td>
</tr>
<tr>
<td>Income and expenditure</td>
<td>Limited business skills</td>
<td>-.416 (.986)</td>
</tr>
<tr>
<td>characteristics</td>
<td>Health problem</td>
<td>-1.013 (.143)</td>
</tr>
<tr>
<td>Problems characteristics</td>
<td>Any other assistance</td>
<td>-.014 (.771)</td>
</tr>
</tbody>
</table>

Source: SPSS estimation output, *significant at 90% of confidence level

7.6. The outreach of ICBMs: overall findings

In the context of ICBM institutions that benefit from Islamic funding resources, outreach is specifically defined as the capability of an institution to provide microfinance services to the poor and the poorest rather than to more financially secure clients. Taking the outreach related findings, together with this outreach definition and insights from the literature review, the following discussion responds to research questions related to ICBMs’ institutional outreach capacity. This discussion also identifies possible key challenges facing these institutions in their attempt to achieve a high level of outreach.
With the exception of BQB clients, the descriptive analysis of demographic profiles shows that clients and non-clients have a similar profile in relation to age, formal education period, and family size variables. Further analysis of poverty levels using a proxy of the average loan balance per borrower shows that ICBM clients are positioned at the lowest poverty level compared to clients of other Indonesian microfinance providers that submitted financial reports to the Mix Market. Further, the survey findings suggest that, on their monthly food expenditure, the majority ICBM’s clients live above the national poverty line. Although these clients are not categorized as poor, they live perilously close to the edge of the poverty line.

The study findings on clients’ poverty levels support arguments in the literature around the idea that microfinance is not suitable for the poorest of the poor (Robinson, 2001). However, this study’s survey findings appear to be contrary to the Islamic microfinance literature in their suggestion that the extremely poor are well served by microfinance institutional programs and services that are funded by Islamic charitable funding sources (Ahmed, 2002, Kaleem and Ahmed, 2009). These client poverty level-related findings may indicate that, contrary to their institutional mission to reach out to the poorest of the poor, ICBMs are not effectively targeting eligible clients within the poorest demographic. The rationale for why client selection outcomes seemingly contradict the aims embedded in traditional ICBM mission statements is examined further in this chapter’s following subsections.

Findings derived from binomial logit modeling of estimates of the possibility of being selected as a client of the case study ICBM institutions were found to support the study findings on the descriptive analysis of client and non-client demographic profiles and poverty level analysis. The model’s estimations indicate that in the case of BMMI and BMB, the participation of clients in ICBM programs is not determined by specific variables and that only BQB selects the most financially vulnerable prospective clients. The findings show that among other variables, a prospective client’s income level is the only variable that significantly influences BMMI’s client selection decisions. BMMI selects clients who enjoy a marginally higher level of income compared to the non-client group. By contrast, findings generated from the BQB binomial logit model estimates indicate that BQB’s clients are selected on the basis of their income level, family size and
identified serious health concerns; whereas in the case of BMB, family size constitutes a key selection variable. Overall, this study found that BQB appeared to be the only one of the three case ICBM institutions that targeted the more financially vulnerable in its client selection processes.

7.7. The rationale for the study findings

The findings from the descriptive analysis of the survey data, the poverty level analysis and the binomial logit modelling show firstly, that only BQB has successfully reached out to the more financially vulnerable groups in society and secondly, that BMMI’s and BMB’s client profiles are similar to the profile of the non-clients group along most variables. These two key study findings raise interesting questions about possible barriers BMMI and BMB face in their efforts to more effectively reach out to eligible prospective clients.

As discussed in Chapter Three, several variables influence the participation of the poor in the microfinance sector. A key focus of this study is the evaluation of a number of ICBM program issues related to the design of institutional products and services, program promotional strategies, selection of client eligibility criteria, and cultural barriers to effective outreach. These issues are taken up in the next subsections.

7.7.1. Product design and outreach

The survey findings revealed that the case study ICBM clients experience a range of limitations in running their microenterprises including, in the main, low levels of education and inadequate business skills training. As such, clients can only engage in low skilled productive microenterprises, such as those found in the micro-retail sector and that are characterized by their minimal returns and high risk of failure. The survey data also documented clients may lack adequate capital to develop their microbusiness on a more substantial and sustainable footing. Further, survey data related to non-financial concerns indicated that many clients face daily problems in meeting their basic needs and protecting their health. These findings suggest that many clients may require
additional welfare interventions to facilitate their participation in the microfinance sector. The literature points out that poor standards of health and wellbeing and a lack of education severely constrain the poor’s participation in microfinance (Morduch and Haley, 2002).

From the case study findings, it appears that case ICBM institutions, for the most part, have been designed to take into account their broad intent to provide poor clients with well-resourced opportunities to develop their own microenterprises. Instead of only offering microloans, the case ICBM institutions provided a package of microloans and other business skills-related assistance through their skills training and mentoring programs and regular group meeting schedules. Both BMB and BMIMI closely mentored and supervised their clients through their weekly meetings. Mentoring programs have a significant role to play in educating and in developing clients’ business skills. BQB’s client programs offer many benefits such as easy access to other social services provided by BAZNAS including education and health services.

One of the success factors of the program is the formation of groups of clients. Group membership is understood to increase the participation of the poor in the program and as social pressure. A previous study by Das and Shams (2012) found that the formation of socially homogeneous lending groups increases the participation of the members in microfinance. Regular group meetings offer opportunities for clients to develop social capital and networks and can promote mutual support and solidarity among participants (Schurmann and Johnston, 2009). The adoption of group lending is likely to be a highly suitable microfinance loan strategy in Indonesian society as this society exhibits features inherent to group lending practices: high solidarity, social support and tight social values such as norms, traditional law and religious values. In this context, the group can also function as a form of social control that encourages and motivates members to follow the group’s norms such attending the weekly meetings, and exercising discipline in making on time loan repayments, in saving a portion of their microbusiness, and in working hard to achieve their goals.

Compared to the other two institutions, BMB’s microfinance programs are more advanced to incorporate cultural aspects into the program. BMB is also able to design
sequential services to clientele with diverse financial and family demographic profiles. As discussed previously, BMB offers a series of empowerment programs over a four year period that provide the poor with opportunities and resources to facilitate their movement out of poverty and into productive income generation activities. Each program is designed around clients’ diverse needs by offering different loan schemes and different mentoring styles. After clients have completed their microfinance program, BMB expect that some clients will become successful entrepreneurs. To enhance clients’ participation, BMB has incorporated cultural aspects into its programs by using local terms to name BMB’s products and services, such as angkringan Simbah Harjo for traditional food stalls and Kompak Harjoni for the becak9 rider program. The mentoring program is also conducted in both Javanese and bahasa Indonesia languages. The use of local terms within its programs by BMB conveys consideration and respect for local cultural traditions and for the distinctive cultural contexts BMB and its clients find themselves in. Demonstrated efforts by BMB management to recognize and acknowledge local culture can do much to promote and enhance community partnerships and support.

The study findings also identified some limitations related to BQB’s program design. In particular the main limitation is the use of personal, or one-to-one mentoring rather than group mentoring. The use of personal mentoring incurs high operational costs and inefficiencies in resource use as discussed in the previous chapter.

7.7.2. Communication and client targeting strategies: impacts on institutional outreach

The lack of participation by the poor in the ICBM program may be related to inadequate promotional strategies on the part of ICBM institutions that might increase prospective clients’ awareness of ICBM programs. The interview data revealed that ICBM programs are promoted to the public through mass media, such as newspapers, websites, through ICBMs’ promotional brochures, and by word of mouth. These promotional methods seem to have a limited capacity to raise the poor’s awareness of ICBM programs. Rather,

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9 A three wheels traditional transportation vehicle
these methods may be more suitable to increase the awareness of potential donors. As a further consideration, prospective clients may have limited access to newspapers and websites, as opposed to potential donors who may access this type of information on a daily basis.

Many of the clients participating in this study indicated through their interview responses that they obtain program information by word of mouth, either from institutional staff, their local mosque, local community organizations or from other clients. Effective client targeting is required to optimize institutional outreach outcomes. Only BMB attempted to adopt a simple method of geographical targeting along with consideration of personal recommendations. The BMB’s geographical targeting is undertaken by identifying a specific location as a basis of client’s selection. This geographical targeting approach to outreach is considered insufficient as it is not supported by reliable data. The data used in this targeting method usually provided by personal information, which may include high level of subjectivity. Geographical targeting can be a powerful outreach strategy to distribute social assistance if it is informed and supported by reliable underlying data sourced from government-affiliated institutions (The World Bank, 2012b). Further, a 2010 World Bank’s research suggested that this targeting method is not suitable for institutions that operate at the local community level such as BMB. Rather, community targeting can be an alternative targeting method to achieve more effective broader and deeper outreach.

7.7.3. The impact of exclusionary ICBM policies on institutional outreach

On the basis of the study’s analysis of client’s poverty levels, the study findings indicated that some of the case study ICBM institutional policies related to client selection might inadvertently be exclusionary in nature. Taking the first example, BMMI requires prospective clients to have an existing business as a condition of their eligibility to participate in its institutional program. Simamowitz and Walter (2002) argues that for poor individuals and families, having an existing business is near impossible due to a lack of education, inadequate or inappropriate relevant business skills and a fundamental lack, or absence of working capital. As such, the institutional policy conditions of business ownership is understood to be exclusionary in the context of inviting the most
needy to take advantage of institutional programs designed to advance clients’ financial standing and enhance their overall standard of living. In other words, the expectation that prospective clients need to have an existing business, by default excludes the participation of the poor and the poorest.

A further example of a policy condition that is likely to be exclusionary in its impact on the poor’s participation is the requirement that prospective clients be actively engaged in their local mosque’s activities. Some poor individuals and groups may, for various reasons, hesitate to become more active mosque participants. The possible reason of this hesitancy is because the poor, compared to society’s middle class, may never have had access to religious knowledge and training and therefore lack the confidence needed to take part in religious observation. Another reason is because the poor have limited time available due to work commitments. This argument is supported by BMB management staff who said that they do not target those who actively participate in their local mosque because many of the poorest, their target clients, do not want to pray in the mosques as they consider themselves less knowledgeable about how to enact the appropriate prayer movements. As a BMB staff member argues: ‘They are shy to go to the mosques because they don’t know how to pray; therefore we do not only select the clients that actively participate in mosques (BMB-1, 2011).’

Currently, the functioning of mosques in Indonesia is undergoing significant change. They are not only functioning as places to pray but also as venues for many other religious activities such as mass education, social gatherings and as Islamic resources centers. On the one hand, using mosques as centers for institutional program delivery may generate several benefits such as reductions in institutional operational costs, opportunities to incorporate religious values into the program’s missions and the opportunity for ICBM institutions to convey a sense of sacredness, honesty, trust and responsibility. On the other, it may make the poor more hesitant to participate in a microfinance program for the reasons offered by the BMB staff member above.

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10 Clarke (2014) has found similar findings in his forthcoming publication of the function of Church in Vanuatu.
Therefore it is argued that this client selection policy condition may also be construed as exclusionary.

A recommendation that flows from evidence of exclusionary client selection policies is that some of these policies need to be redeveloped to optimize the poor’s participation in ICBM. It is interesting to note that participation in various government social assistance programs may also be hindered by a lack of reliable poverty-related data that might more accurately identify eligible participants. Although compared to ICBMs, government social assistance programs employ more advanced targeting strategies such as geographic targeting, community targeting, and survey targeting; these strategies have failed to provide reliable data on financially vulnerable households most in need of government social assistance (The World bank, 2011). Alatas et al. (2010) estimate that of eligible poor clients only 33 percent participate in the government rice program, 36% in health related programs, while only 46% qualify for unconditional cash transfer.

A similar story of a lack of participation by the poor in the ICBM sector can be evidenced in government run social assistance programs. This story points to more fundamental culture-related factors at work to exclude the poor than those evident in the exclusionary conditions identified in microfinance institutional policies. These factors can also be seen as cultural barriers standing in the way of effective institutional outreach.

### 7.7.4. Cultural values and their impact on institutional outreach

Many of the poorest are excluded from microfinance development programs due to self-exclusion and cultural barriers. Cultural barriers play a significant role in excluding the poor from participating in ICBM institutional empowerment programs and may explain the lack of participation of the poor in BMB’s and BMMI’s advanced programs.

The study findings have identified several cultural factors that may exclude the participation of the poor: a patriarchal society and an accepted culture of poverty. Indonesian society, particularly in Java, is characterized by its highly patriarchal norms, rules and regulations. In a patriarchal society, women play a homemaker role with responsibility for domestic duties, while men play a role in providing the family income.
Zhao and Wry (2012) argue that patriarchal societies limit the extent to which institutions can reach out to women. In such male-dominated societies, women have few opportunities to participate in the microfinance sector. To some extent, this study reflects Zhao and Wry’s (2012) study findings in that the case study ICBM client profiles, revealed through the descriptive demographic profile analysis, illuminate the dominant role men play as the household head even though women loan clients made up 80% of the research survey sample. For example, the reluctance of the BMMI and BMB’s women clients to participate in more advanced loan programs may be due to the possibility that the male household head may exert control over loan funds women in the family have borrowed. This situation may mean that that loan funds may be put to purposes other than those intended by the women borrowers.

Another cultural barrier is the culture of poverty itself. The notion of a culture of poverty emerged in the 1960s as states of ‘being’, such as being marginalized, being perceived by society’s more powerful as inferior, and seeing oneself as caught in a downwards spiral of helplessness; states of being that can be passed to younger poor generations (Lewis, 1971). Lewis’ study found that a culture of poverty was evident across different sectors of the poor in different countries. A culture of poverty is also evident in poor societies in Indonesia. The study by Setiawati and Guritno (1997) evaluates the government program of Inpres Desa Tertinggal (IDT) in the Probolinggo district of East Java. These researchers painted a distinctive portrait of the poor. Compared to the more financially secure, the poor are more introverted, participate less in formal organizations and have children who, as a result of their income earning responsibilities, experience relatively shorter childhoods and lack education and workrelated skills. Setiawati and Guritno’s (1997) portrait reflects some of Lewis’ (1971) theory on the culture of poverty.

The existence of a culture of poverty in society can partly explain why poorer levels of a community have low rates of participation in microfinance programs. Setiawati and Guritno (1997) found that the poor do not want to participate in government managed social assistance program of IDT for reasons to do with a lack of resources such as time and skills, a lack of confidence, and feelings of anxiety and apathy. As Lewis (1971),
argued a sense of personal and social efficacy is highly influenced by the holding, or not of hopeful visions of the future.

The life of many Indonesians, particularly the poor, is driven by the value of ‘being content’ and ‘being happy’ with their existing condition. In Javanese culture, dominant in this study, several terms acknowledge the importance of ‘nrimo’ (being content) and ‘sabar’ (being patient) in facing life’s obstacles. Life is often symbolized by the wheel of a carriage that can be either in the top position, or in the bottom position. For the poor, being poor is a kind of destiny that has to be faced. These values influence how the poor view the future. For example, in Yogyakarta, BMB’s staff member said that clients’ conceptualization of profit is very limited. As said by BMB’s staff member: ‘for them profit is when they can still buy the inventory tomorrow’ (BMB-1, 2011). Interestingly, this future conceptualization aligns with a popular Javanese proverb that says ‘ana dina ana upo’ (When there is a day, there will be rice to eat). This proverb teaches people to be optimistic about their lives as they believe that they will not be hungry because the God is the giver (Gusti Allah maha mirah). These values suggest that Indonesians, in particular the Javanese, have a very limited idea about what their future holds, as for them life is just the flow of water that can go anywhere it can. This future-oriented worldview could be understood as fatalistic in the sense of being ‘determining’: what will be will be (Hidup seperti air mengalir). In Indonesian society, traditional views of the future as ‘fatalistic’ may explain why some poor are reluctant to participate in microfinance programs that are intentionally designed to offer what they may perceive to be a circumscribed path towards a more empowered and financially secure life.

Additionally, participation in the financial credit market is a new tradition in Indonesian, particularly for the poor. Traditionally, being ‘in debt’ was seen as an inferior position in which the debtor was understood to be lacking in self-reliance and respectability. Many of the poor believe that obtaining credit is similar to adding an additional burden to their life. They are unsure about their ability to repay a loan as most of their income is needed for everyday expenditure on life’s essentials such as, as a minimum, safe food and water, and secure shelter.
7.8. Conclusion

This chapter presented a discussion on issues around the achievement of outreach as one of the key objectives in the effective management of ICBM institutional funds in Indonesia. Overall, the study findings reported in this chapter highlighted how the selected case study ICBM institutions’ programs have been designed to provide opportunities for the poor to generate income through microenterprise development strategies.

The study’s findings point out a lack of participation by the poorer in both BMMI’s and BMB’s microfinance programs. In the case of BMMI, it is argued that this institution’s limited ability to reach out more expansively to the poor may be due to exclusionary conditions found in this institution’s client selection policies. In the case of BMB, it is argued that the lack of participation of the poorest is due policy related concerns but rather, society’s cultural norms and values, particularly those norms related to marginalization of the poor that inevitably lead to self-exclusion by the poor from microfinance development program. In this sense, the poor put themselves out of reach of ICBM institutions.

In contrast to BMMI and BMB, the study found that BQB’s microfinance programs are less effective in running its mentoring and group support as well as in designing its advanced microfinance programs. The study findings show that BQB is able to reach out to the poorest in the community. It is argued that the main outreach success factor for BQB lies in BQB’s development of a selection mechanism that requires clients to provide comprehensive information about their financial standing and to have this information verified by institutional staff.

Findings related to the lack of participation of the poor appear to contradict research findings reported in the existing Islamic microfinance research literature that claim ICBM institutions in general could demonstrate a capacity to extend their services more widely to the poorest if Islamic charity is the main source of microfinance funding. This finding also leads to a dilemma as reflected in the question: To what extent should ICBM maintain a sharp focus on the poorest, while at the same time attempt to achieve
their institutional sustainability? This question will be taken up in the following chapter by examining the necessary elements of institutional sustainability and outreach, and proposed models for the future development of the ICBM sector in Indonesia.
Chapter 8

The future of Islamic charity based microfinance in Indonesia

8.1. Introduction

The case study findings presented in the previous chapters illustrate a number of features of the microfinance sector in the context of Islamic charity based institutions (ICBM) in Indonesia. Firstly, in contrast to conventional microfinance institutions that rely on commercial and donor funding, ICBM institutions rely on Islamic charitable funding to provide microfinance services to society’s poorest. Second, ICBM institutions are guided by sharia compliance to meet the dual objectives of institutional sustainability and outreach. Thirdly, ICBM’s clients are offered a range of loan schemes and mentoring support programs designed to meet poor clients’ diverse needs and poverty circumstances. From this snapshot of these three distinctive features, the success of an ICBM institution cannot be evaluated solely on its ability to achieve financial sustainability in order to continue to serve a wide number of outreach, as traditional microfinance is evaluated. Rather, success rests on the institution’s capability to generate funds from charitable funding sources in order to provide financial and non-financial products and services to its intended clients.

The case study analysis shows that existing ICBM models face both structural and individual challenges in providing financial services for the poor. However, as argued in this thesis, the ICBM sector should play a greater role in strengthening both its inclusionary stance and its efforts to alleviate poverty in Indonesia by drawing on the significant potential of Islamic charitable funds to provide a sustainable funding base.

The objective of this chapter is to develop possible future model of ICBM that can achieve high levels of sustainability and outreach by developing the strengths and limiting the weaknesses of the existing ICBM models earlier discussed. The thesis proposes that ICBM should not provide financial services directly to the poor. Instead,
ICBM institutions should play a role as a preparatory institution that builds the capacity of zakat recipients to enhance their participation in financial services.

The discussion in this chapter is structured around five key themes: Section 8.2 presents the proposed role of ICBM in the microfinance industry in Indonesia; Section 8.3 explains key elements integral to the creation of sustainable ICBMs; Section 8.4 explains key elements integral to the creation of poverty-focused ICBMs; and Section 8.5 proposes a model for ICBM microfinance in Indonesia. The last section’s brief overview of each theme concludes the chapter.

8.2. The proposed role of ICBM in Indonesia

In the last ten years, Indonesia has demonstrated significant economic growth and has made remarkable progress towards reducing poverty through effective and well-resourced social assistance programs. The poverty rate has shown a significant decrease from 23.4% in 1999 to 11.96% in 2012 (BPS 2012). The Indonesian Statistical Bureau (BPS) March 2012 data indicated that the number of people living in poverty is 29.13 million people, or 11.96% of total population. This figure fell by 0.89 million people or 0.53% last year. Yet, declining poverty rates do not, on their own portray an accurate picture of the extent to which individuals and households, clustered just above the poverty line, are becoming increasingly vulnerable to falling into conditions of poverty and destitution. A 2012 World Bank study found that 50% of Indonesia’s recently poor were not poor in previous years. These financially vulnerable households’ monthly per capita expenditure is around 1.5 times that of the national poverty line benchmark. The remaining 50% of households have lived in chronic poverty conditions at least once in the three years prior to the World Bank study. Of this segment, 10% remained in chronic poverty for three consecutive years. Income inequality within regional provinces is also significant. In rural areas of Java, around 12% of people live in poverty, compared to eastern regions of Indonesia, where around 70% of the population is considered poor (The World Bank, 2012b).

Persistent and pervasive conditions of chronic and acute poverty present an ongoing challenge to the Indonesian government. Efforts to alleviate these conditions through
dedicated social assistance and safety net programs are further thwarted by the government’s limited social assistance budget, at only $4.6 billion per annum, or 0.5% of Indonesia’s 2010 gross domestic product (The World Bank, 2012a). Funding for social assistance programs is severely constrained, such that these programs can reach only half of the total 29.13 million poor in Indonesia.

At the center of this thesis’ argument is the proposition that inclusionary microfinance programs represent a key strategy in the alleviation of poverty in Indonesia. Specifically, the provision of such programs through the ICBM sector have the potential to provide opportunities for poor individuals and households to accumulate assets, generate income and eventually contribute to the local and national economy (Bank Indonesia 2011b). The development and implementation of financially inclusive strategies represent a significant challenge in Indonesia. A 2013 Bank Indonesia report shows access to and take up of financial services in the population generally is still limited with only 19.6% of adults holding any type of banking account with a formal financial institution. This rate of participation in the finance sector is the lowest of many other countries in the region: Malaysia (66.7%), Thailand (77.7%), the Philippines (26.5%), and Vietnam (21.4%) (Bank Indonesia 2013). Such a low rate of participation by the population in the commercial banking sector is due to at least two major obstacles. From the banking perspective, issues around cost, risk and product suitability and acceptability constrain what the commercial banking sector can offer poor clients. From the clients’ perspective, low levels of education, a lack of businessrelated knowledge and skills, feelings of anxiety associated with dealing with financial services, and challenges in meeting client eligibility criteria, set up seemingly insurmountable barriers to the poor’s access to financial products and services (Bank Indonesia, 2011b).

The financial sector in Indonesia is currently dominated by highly profitable commercial banks that do not include the poor in their target markets and have limited presence in low level society of Indonesia’s eastern regions of Indonesia (Bank Indonesia, 2013). Similarly, as first pointed out in Chapter Five, the microfinance and Islamic microfinance sectors are also dominated by commercial institutions that target high income earners, effectively excluding a significant percentage of the poor who cannot meet these financial institutions’ client eligibility criteria. The data from the 2010 World
Bank study show that 60% of Indonesia’s poor live in remote rural areas and as a consequence, have limited access to suitable and acceptable financial sector products and services (The World Bank, 2010).

To address issues around increasing the poor’s access to financial products and services, the Indonesian government has developed a national strategy on financial inclusion framed around six strategies that aim to strengthen collaboration between all financial sector stakeholders (Bank Indonesia, 2013). This national strategy includes the participation of the government and two major financial sector agencies: commercial banks and non-bank financial institutions. However, this strategy has neglected to include civil society organizations such as zakat institutions that have the potential to play important roles in Indonesia’s social development programs (Bamualim, 2009). This study strongly suggests that the Islamic charity sector could play a greater role in increasing and expanding participation opportunities for the poor by offering suitable services or partnering with existing microfinance providers.

There are several reasons to support an argument for the inclusion of ICBM in the microfinance industry. The first reason is premised on a common understanding that the major providers of microfinance will not serve the poor due to the high costs involved and low profitability rates from doing so. Alternatively, non-profit institutions, guided by socially oriented mission statement aims, rather than profit making imperatives, are likely to be in a more suitable, acceptable and feasible strategic position to target the needy and poor as prospective clients.

With the largest Muslim population in the world, Indonesia benefits from the potential of Islamic charities to generate funds amounting to $21.7 billion, or 3.4% of Indonesia’s 2010 GDP (Firdaus et al., 2012). Data from the National Board of Zakat indicates that Islamic charitable funding collected by zakat institutions has increased significantly since 2002, with annual growth of at least 24% annually since 2003 (see Table 8.1).
Table 8.1. The collection of Islamic charity in Indonesia

<table>
<thead>
<tr>
<th>Year</th>
<th>The amount of Islamic Charity (million US$)</th>
<th>Annual growth (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>7.2</td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td>8.98</td>
<td>24.7</td>
</tr>
<tr>
<td>2004</td>
<td>15.8</td>
<td>76</td>
</tr>
<tr>
<td>2005</td>
<td>31.11</td>
<td>96.9</td>
</tr>
<tr>
<td>2006</td>
<td>39.28</td>
<td>26.28</td>
</tr>
<tr>
<td>2007</td>
<td>77.89</td>
<td>98.3</td>
</tr>
<tr>
<td>2008</td>
<td>96.84</td>
<td>24.32</td>
</tr>
</tbody>
</table>

Source: The National Board of Zakat (2011)

The current motivation of zakat organizations to take a part in microfinance initiatives is likely grounded on their preference for distributing Islamic charity in ways that can provide sustainable interventions into microenterprise development, rather than funding for everyday consumption needs. This ICBM practices have received limited attention from the government, particularly issues around limited supporting regulations on ICBM practices.

The second reason to support the development of the ICBM sector in enhancing financial inclusion is due to the generally close proximity of ICBM institutions to the poor. One of the obstacles to the provision of financial services to the poor noted in this study relates to cultural values that constraint the participation of the poor in the mainstream formal financial services sector. ICBM has greater potential to address the poor’s funding needs through financing and microenterprise education and skills training programs as they can more closely interact and work with this community.

Although the study has documented the participation of three ICBM institutions through a case study approach, the case study findings suggest that existing models of ICBM in Indonesia continue to face various challenges in achieving institutional sustainability and in effectively reaching poor clients. The study has identified significant efforts by the selected ICBM case study institutions to develop innovative microenterprise-related programs, to establish sustainable sources of fundraising and to
manage governance issues such as public accountability. However, the lack of community support, highly institutional dependency on zakat funding sources and the lack of an effective regulatory environment inclusive of the ICBM sector, represent major obstacles to ICBM sustainability.

Additionally, the outreach evaluation discussion in the previous chapter pointed out that ICBMs face various constraints in reaching the poor and the poorest in the community. As has been discussed, issues around institutions’ client eligibility and the client selection process, along with possible cultural barriers, might in concert, hinder more extensive inclusionary outreach outcomes. Therefore, on the basis of the potential adverse impact of these issues on institutional sustainability and outreach, it is argued that it is necessary to redesign existing ICBM models in Indonesia. In general, the objective of the proposed model is to create a sustainable and poverty focused outreach ICBM that can increase financial inclusion in Indonesia. The discussion in the following subsection identifies the necessary constituents of the proposed ICBM model.

8.3. Towards a sustainable ICBM

The achievement of institutional sustainability, first discussed in Chapter Three, is understood to be one of the two key objectives of microfinance. Drawing from the study findings on institutional sustainability presented in Chapter Six together with literature review insights, this section aims to identify the strategies required to achieve institutional sustainability in the ICBM sector in Indonesia.

The study findings suggest that, despite the major structural concerns about the lack of regulation in the ICBM financial sector in Indonesia, there are several institutional challenges to the achievement of sustainability. To exemplify, the study has identified that ICBM institutions’ dependency on zakat funding is likely to lead to problems such as low loan repayment rates due to a public perception of zakat as offering ‘free money’, complexities in complying with sharia law, and the need to effectively and efficiently manage limited operating budgets. Unresolved, these issues may jeopardize institutional sustainability.
The findings reported in this thesis accord with a previous study by Obaidullah (2008) and Ahmed (2002; 2007). *Zakat* is an important source of poverty intervention funding, much needed to facilitate the participation of the poor in the productive economy initiatives. *Zakat* intervention programs have the potential to alleviate poverty through the provision of funding to ensure that individual’s and families’ basic everyday needs are met, to provide necessary training and education programs, and to provide asset grants to enable loan clients to develop income-generating microenterprises. As noted in Chapter Two, the poor may need to engage with a number of preparatory programs before being ready to take up the responsibilities of being identified as a microfinance client.

In addition to *zakat*, and to ensure that the poor can take advantage of a range of ICBM institutional poverty alleviation resources, *shadaqa* and *waqf* can be used to extend services by providing *qard hassan* loans and commercial Islamic transaction schemes. *Waqf* can be invested, in which the proceeds of the investment can be used to provide *qard hassan* loans and to subsidize Islamic lending schemes. Furthermore, ICBM institutions could be integrated into the commercial Islamic microfinance sector to strengthen further funding source possibilities. This idea has been proposed by several scholars including Ahmed (2002) and Hassan (2010) as discussed in the literature review in Chapter Two.

The study also found that *zakat* funding alone is not sufficient to cover the ICBM institutions’ operating costs. The analysis of the case studies suggested that cost constraints as a result of a minimal operating budget hinders the payment of competitive staff salaries and in turn, this means that institutions may find it difficult to recruit high performing staff. This problem can also jeopardize the sustainability of the institution since all staff, particularly the fieldworkers, play major roles at every management level and are involved in the implementation and monitoring of ICBM programs.

Three key strategies are suggested as ways to enhance ICBM institutions’ revenue generation and to limit operational costs. These strategies involve firstly, the effective targeting of middle income class and corporate segments as potential *zakat* donors by promoting of Islamic charity incentives in order to reach underexplored potential of
\textit{zikarat} and Islamic charity collection, second, the creation of volunteerism opportunities that may lead to cost efficiencies, and third, the adoption of self-employment schemes in the ICBM sector.

8.3.1. Reaching the underexplored potential of \textit{zikarat} and Islamic charity collection

In Indonesia, there has been a significant shift in the ways \textit{zikarat} funding is managed from private donation to a more formal institutional style of financial management. As a new tradition in Indonesian society, only a few of those undertake \textit{zikarat} payment through the institutions. The realization of Islamic charity potential is still very limited. One reason for this may be a lack of institutional understanding of \textit{zikarat} donor characteristics. It is argued that understanding these characteristics is a key to successfully attracting potential donor participation in the institutions’ range of microenterprise development programs.

\textit{Zikarat} funding is derived from private individual donations and from the corporate financial sector. It is argued by the researcher that one of the possible explanations for the increasing amounts of Islamic charitable funds donated by institutions is due to the increase in the middle class\footnote{Middle class that is defined as the population with daily expenditure around $US2-20 per day (The World Bank 2011)} population in Indonesia, as such, this population may be classified as a potential source of \textit{zikarat} donors. As Indonesia’s economic growth continued to increase, evidenced at above 5% over the five years from 2006 to 2011, so too the growth of the middle class (Verra and Fitriani, 2012). The World Bank data indicates that by 2011, the middle class population had reached more than 134 million, or over half of Indonesia’s total population (The World Bank, 2011). This population class plays a powerful role in driving the Indonesian economy as the total consumer spending from this class represented 55% of Indonesia’s 2011 GDP. Consequently, the financial status of the rising middle class has direct implications for the business sector and simultaneously for the Islamic voluntary sector. As the middle class may attain the minimal threshold level of income at which \textit{zikarat} donations are required (\textit{nisab}), a significant amount of \textit{zikarat} funding could be available from this middle class sector.
A study by Nielsen (2012) examines the characteristics of the Indonesian middle class. Nielsen (2012) argue that this middle class is captivated by a wide and growing range of consumer products and communication technologies such as television, mobile phones and internet (Eddy and Pratignyo, 2012). To successfully connect to the middle-income class, the business sectors have to adapt the characteristics of the middle class into their products and services. Given this observation that the middle class enjoy a high level of engagement with communication technologies such as mobile phones and social networking, institutions need to develop technology based fundraising strategies to attract potential middle-class donors. Technology based fundraising enables donors to donate using mobile internet applications and institutional websites in secure and convenience ways. Websites and social networking offer powerful and cost efficient ways to communicate both the obligation to pay zakat and the benefits and objectives of the institutions’ microenterprise development programs.

In addition to individual donation sources, the opportunity remains to generate charitable funds from the private corporations. Company Social Responsibility (CSR) funds are an alternative flexible source of funding that can be utilized in many microfinance programs. ICBM organizations could develop partnerships with private companies to access these CSR funds.

There are two lesser-known features of Islamic charity that deserve greater public attention. Specifically, these features are, firstly, the use of income tax deductions as an incentive to become a zakat donor and second, the existence of an institutional network for making donations through the cash waqf scheme. The promotion of these two features is crucial to enhance ICBM’s revenue generation. The Indonesian government has supported zakat donations through the institutions by providing incentives to zakat donors who donate via the 19 government-approved institutions. The claiming of zakat donations as an income tax deduction is regulated by zakat management law 38/1999 and is mentioned in taxable income law 36/2008 and the government law 60/2010. The study by Siswantoro and Nurhayati (2012) found that only 0.8% of their respondents collected restitutions from surplus tax payment on zakat suggesting that neither members of the public, nor Indonesian tax officers were sufficiently aware of the
income tax deduction incentive. This incentive should be more widely promoted to increase the collection of zakat by the institutions.

The concern expressed earlier in the thesis related to institutional dependency on zakat may be addressed by attempts to generate alternative types of charitable funding. For example, cash waqf should be promoted as the most flexible and sustainable source of charitable funding (Mannan 1999; Masyita 2010). As discussed in Chapter Three, cash waqf is a type of Islamic endowment fund that is distributed in the form of cash or money. Cash waqf can be utilized to provide public and private goods such as education and health facilities. It is also important for empowering micro entrepreneurs who may lack access to conventional financing resources. Meanwhile, if cash waqf is managed and invested professionally, cash waqf will generate profits that can be utilized as funding instruments in poverty alleviation. The crucial issues to do with cash waqf collection in Indonesia is to rise community awareness of the benefit of cash waqf to the society as well as to inform methods and an existing institutional network of making cash waqf donation in Indonesia.

8.3.2. Attracting community supports

The case study analysis shows that community support for ICBM institutions in Indonesia is minimal. This is of concern as community support is a crucial driver of the achievement of institutional sustainability in the non-profit microfinance sector (Khan, 2011, Kaleem and Ahmed, 2009). The experience of the ICBM institution Al Akhuwat in Pakistan shows that this institution has been able to develop as a sustainable institution using the spirit of volunteerism and brotherhood. The organization is able to reduce operational costs through the use of volunteerism, whereby management level staff work on a voluntary basis, while lower level staff are paid at competitive salary rates. In this way, the institution can spread the value of volunteerism to the whole organization such that staff are motivated to perform at higher levels.

Along with management level staff volunteers, volunteers can be drawn from the local university’s final year, or from the pool of newly graduated students. With adequate training, students are capable of taking on the mentoring of institutional clients. It is
argued that volunteering programs can be successful if well-designed and effectively communicated as brotherhood and volunteerism is part of the original culture of Indonesia.

8.3.3. Adopting self-enterprise schemes

An alternative mechanism to enhance institutional revenue is through the adoption of self-enterprise schemes within a non-profit organization. A self-enterprise scheme is a separate profit generating entity, which supports the non-profit organization with revenue and reduces dependency on zakat donors. This entity supports the mission indirectly through its revenue stream, but in some cases it can be mission related (Sommerrock, 2010). The enterprise scheme emphasizes innovation and the combining of resources to pursue opportunities that may catalyze social change and/or address social needs (Mair and Martí, 2006).

There are several arguments why ICBM institutions need to adopt enterprise schemes. Firstly, an increasingly competitive and changing industry environment has, according to Weerawarden et al.’s (2010) research findings on nine non-profit organizations in Australia, meant that these non-profit organizations have to adopt a “business like strategy”. In addition to the changing business environment, a lack of funding has forced the non-profit sector to find other financial support to be able to sustain its mission (Kickul and Lyons, 2012). Secondly, the adoption of enterprise schemes provides opportunities for institutions to diversify income sources through developing a separate profit oriented entity within the organization. Given the limited capability of zakat as source of microfinance charitable funding due to sharia constraints means institutions need to expand their income sources to include commercial income from their profit making entities. As evidenced in the BMMI case study, this institution has initiated some profit entities to generate financial support for its social programs. This initiative needs to be supported and promoted to achieve wider implementation.
8.4. Towards poverty focused microfinance

The second microfinance objective is outreach. In the context of ICBM, as earlier discussed in Chapters Three and Seven, outreach is defined as the capability of the institution to provide microfinance services to the poor and the poorest rather than to more financially secure clients. The objectives of the discussion in this section are to propose strategies designed to achieve outreach, as defined, by creating poverty-focused sustainable microfinance program.

Poverty-focused microfinance is a type of microfinance program that is specifically designed to benefit the poorest and to facilitate intervention strategies in the hope these will produce desirable outcomes to create impact on poverty alleviation. ICBM institutions need to maintain their services to the poor and the poorest in the community in order to increase their participation in Indonesia’s financial sector. The organizational vision and commitment of institutions and all their staff are keys to the achievement of a wide and inclusive outreach (Simamowitz and Walter, 2002).

8.4.1. Program design

As earlier discussed, this study found that in Indonesia, the design and effective implementation of ICBM programs are key contributing factors to successful outreach. As evidenced in the case study, ICBM programs are designed to include a range of financial and non-financial services. Financial services provide interest-free loans as start-up capital for microenterprises, while non-financial services, such as the provision of client training and mentoring programs and the formation of support groups, are designed to assist clients take advantage of the opportunities ICBM financing products offer. These services embrace cultural values and incorporate the diverse needs of the clients. These services can be replicated with some adjustment and modification to fit multiple microfinance and Islamic finance contexts.

Before designing the programs and developing the products and services, ICBM institutions should firstly, aim to understand the needs and concerns of their clients. Inappropriately designed, inaccessible, and inflexible savings and loans products work to
exclude the poor (Fernando, 2004). The capability of the institution to create products and services in meeting the needs of their clients in concert with the adoption of a market oriented culture may enhance the possibility of successful program outcomes and facilitate institutional sustainability (Dunn 2002; Woller, 2002). Hence, the institution needs to use its initial market survey to collect information about the profiles of prospective clients. The design, implementation and data processing of market surveys can incur significant costs. However, these costs can be minimized if the institution has selected a specific area and has used a focus group discussion method, rather than questionnaires to identify the needs of prospective clients. Survey questionnaires may present a daunting challenge for those who may have limited literacy skills.

The survey findings revealed that many ICBM clients face a number of challenges, including financial difficulties in meeting their basic everyday survival needs. Serious personal, or family health concerns, and limited microenterprise businessrelated skills pose additional challenges. Therefore, ICBM programs should include a range of integrated services, including health and education programs, skills enhancement training and basic financial advisory services. Additionally, it is suggested that ICBM institutions should provide financial literacy training as some case study findings indicated that clients may have a limited understanding of financial transactions. Educating clients about asset accumulation and financial management, including budgeting may increase their motivation to move out of poverty.

The second important element of ICBM product design is the establishment of client group meetings. These meetings can provide benefits for institutions and their clients. From the clients’ perspective, group membership can function to increase social capital and solidarity that may in turn increase clients’ motivation to participate (Dusuki, 2008). From an institutional perspective, group meetings can be an effective and cost efficient way to deliver training and collect loan repayments.

The third necessary element is the adoption of cultural values into the program. As described, ICBM’s clients generally have limited formal education. Limited formal educational experiences may be associated with having limited skills, including limited
language acquisition. A 2013 study by Fanany suggests that those who have limited
language and literacy skills find it harder to compete in urban environments. As
Indonesia has over 700 local indigenous languages with the national language Bahasa
spoken mainly in urban areas such as Jakarta (Fanany, 2013), the urban migrant poor,
accustomed to speaking their local language, may not be able to use bahasa Indonesia
effectively in social interactions. In the context of ICBM, such language limitations are
likely to severely impact on potential clients’ level of confidence to participate in ICBM
programs. As ICBM programs including group meetings and mentoring are conducted
in bahasa Indonesia, this might dissuade the poor’s participation. Therefore to be
successful in reaching the urban poor, institutions need to incorporate language-specific
cultural aspects into their programs by employing local staff to conduct multilingual
programs in both bahasa and local languages.

A fourth component of the program is the provision of continual services for graduates
of the institutions’ programs. These continual services mean that if clients have been
successful in the use of their initial loans funds, they should be able to have access to
intervention related support services and resources that provide a long term path for the
returning client to sustain their new microbusiness and to further develop as a successful
micro entrepreneur.

8.4.2. Targeting and client selection

The findings reported in this thesis suggest that the case study ICBM institutions
identified limitations in their client targeting strategies that as a consequence, hindered
the selection of eligible ICBM clients. Hence, more intensive efforts are needed to
develop more finely tuned targeting strategies and to identify appropriate client selection
eligibility criteria. It is argued that one of the more important client targeting criteria
relates to selecting poor clients who are not already managing an existing
microenterprise.

The case study findings suggest that only BQB was found to use a survey mechanism to
select eligible clients. BQB’s client selection strategy demonstrated a capacity to include
the poorer member of the society. Some other ICBM institutions followed personal
recommendations from local affiliated institutions to select clients. In some instances, due to ineffective ill-informed client targeting guidelines, non-poor have been selected. Currently, as each institution’s sharia compliance board determines client eligibility criteria; there is a possibility that these criteria could be interpreted in multiple ways. To limit possible interpretive confusions and inconsistencies, it is recommended that ICBM client eligibility criteria should be determined by The National Sharia Board\(^\text{12}\). These criteria could be used to as a benchmark by zakat organizations in selecting prospective clients. In addition, this study appreciates the urgency of the need to develop a national database of mustahik (zakat recipients) that includes a profile of Indonesians eligible to receive Islamic charity. This data base, which may include comprehensive information about prospective clients’ economic and social status, and their residential location, could be built from the available existing household level data generated by the national survey of social and economic demographic profile provided by Indonesian Statistic Bureau. A national mustahik database could be used to inform client targeting strategies, particularly at the local community level.

Other microfinance providers have implemented several successful targeting strategies. For example, the BRAC utilizes a combination of geographical targeting, participatory wealth ranking (PWR), questionnaires and verification processes in their client targeting. Participatory wealth ranking processes have been successfully implemented in the Small Enterprise Foundation (SEF) in South Africa (Simanowitz, 1999). This targeting method collects information about the poorest in the community by conducting meetings at which a community representative ranks household poverty levels (Simanowitz, 1999). This method is premised on the rationale that, in contrast to more geographically and culturally distanced microfinance institutions; the community itself knows and has a deeper understanding of its poor members, of their diverse circumstances and their urgent need for welfare and financial support services.

The PWR process could also be implemented in Indonesia as in the society there are within existing regular ‘social gathering’ mechanisms such as arisan (informal self-help groups in saving and lending rotation), or pengajian (religious mass education).

\(^{12}\) National Syariah Board is the division of Indonesian Islamic Jurist (MUI)
Approaching the community through these mechanisms could be a viable means by which to gather information about poverty in the community.

After identifying the necessary elements of a successful ICBM institution, the discussion in this chapter now turns to propose a model for ICBM. With some contextual modifications and suggested improvements, the ICBM model proposed in this thesis aligns with the early stages of the poverty graduation model of the CGAP and the Ford Foundation (see Hashemi and Rosenberg, 2006; Hashemi and Montequiou, 2011) and the Targeting the Ultra Poor model of BRAC in Bangladesh (see Hulme and Moore, 2010).

8.5. A microfinance model for ICBM institutions

The main reason why Islamic charity institutions participate in the microfinance sector is to enhance the benefits charitable funding of microfinance programs can bring to society. Rather than distributing Islamic charity funds directly to the poor, Islamic charity institutions find alternative mechanisms through which to distribute Islamic charity productively informed by their obligation to comply with sharia law. The focus of the following discussion is on the roles that ICBM institutions could play in the microfinance sector.

This thesis argues that the major role of an ICBM institution is to prepare the poorest for their participation in the microfinance sector through the provision of sequential interventions to enhance the poor’s productive capability, rather than through offering direct financial products and services to the poor. This role certainly fits with the nature of Islamic charity institution as non-profit organization not as financial institutions. ICBM institutions take on five roles in preparing the poorest for their participation in Islamic charity-funded microfinance programs: ensuring participants’ basic survival needs are met, assisting clients to develop savings habits, providing business skills training and motivational programs, providing grants for developing community and cottage industries and providing benevolent loans. The first four roles can be funded by zakat funds while the fifth role should draw on other types of Islamic charitable funding sources (i.e., waqf and shadaqa/CSR).
These distinctive roles need to be strategically linked with sequenced programs that run over a period of two to three years after which time participants graduate as prospective microfinance clients. Hulme and Moore (2010) argue that the poorest cannot benefit from a single intervention; rather they require a sequenced set of supports that provide them with livelihood security, help build confidence, and further develop their business and financial management skills.

The first role of an Islamic charity institution is to ensure that the most eligible participants are selected. Prospective clients could be targeted on the basis of local potential or of the immediate needs of people living in areas hard hit by severe natural environmental events (e.g., monsoonal flooding, earthquakes, droughts). Alternatively, clients could be selected based on their geographical location.

Throughout the entire program, close and periodic mentoring needs to continue to ensure the success of the program. The focus of mentoring activities depends on the particular intervention stage. In the early stages, mentoring activities would be designed to increase clients’ motivation to run a small business successfully and to build confidence in their ability to do so (Simanowitz, 1999).

During the first three months of their participation, clients would receive financial support to meet every day basic consumption needs. The objectives of this support are to stabilize clients’ income and reduce their vulnerability to malnutrition. Such support means that poor clients do not need to work excessively long hours in order to pay for their basic consumption needs and as a consequence, would have more opportunities to attend group meetings (El-Zoghbi et al., 2009).

In the next phase, and for the duration of their participation in the program, participants would be encouraged to voluntarily save a small amount of their income and deposit this when attending the group meetings. Participants’ voluntary savings would be kept in an ICBM organization until the end of the program. This step is intended to educate participants about the immediate and longer-term benefits of good financial management. The study findings indicated that for the case study ICBMs, clients’ saving is common practice. Interestingly, clients’ motivation to save was not necessarily in
order to build an asset base, but for shorter-term purposes such as for religious celebrations. Mentoring support in this stage is designed to assist participants’ understanding of simple financial planning in order to help participants better understand their financial needs and use their savings effectively. Access to sound financial education programs is crucial to enable those with little education to make critical well-informed financial management and life goal decisions.

The next step in the client preparatory program is the provision of technical skills and business training programs for participants who have limited business-related technical skills. Client groups could be developed based on professional groupings in the locality likely to be served by ICBM, such as fisherman, farmers, and craftsmen. The organization of clients into similar professional groupings is preferable as this arrangement allows ICBM institutions to provide specialist technical skills training for their participants. Once participants have achieved a particular level of competency in the required skills, they would receive either a grant, or an asset transfer in the form of productive assets such as machinery and livestock to facilitate participants’ entry into a productive microbusiness.

Some clients may have limited entrepreneurial skills or ideas for developing a business. It is evident from the case study findings that many clients use the *qard hassan* loan to start up their micro retail businesses. These types of low return businesses operate in a highly competitive environment. For these clients, the institutions may develop cottage industries, or community businesses in which clients contribute as either a producer or supplier in the production chain. The batik industry in Pekalongan provides a good example of a community business. In this community business, the ICBM organization manages a garment corporation that produces fashion clothing. In running this type of corporation, the clients would be treated as business partners/subcontractors with responsibility for different roles in the production chain.

The process of close monitoring and supervision needs to be on going in its support of clients’ efforts to succeed in their businesses. After a certain period of between 24 to 36 months, clients would be expected to have gradually moved out of poverty. These graduates are now likely to be ready to participate in an appropriate microfinance
program with access to larger commercial loans from mainstream microfinance institutions. In this sense, ‘to graduate’ means that the participant has reached a stage where a sustainable livelihood is within their grasp without the need for further ICBM funding, or subsidies.

This model, as proposed in the argument above, has the potential to be successfully adopted by ICBMs in Indonesia for several reasons. Firstly, ICBM institutions have sufficient resources to implement subsidized microfinance programs that offer the poor opportunities to move into more prosperous and productive means of income generation. Islamic charitable funding, particularly of the *zakat* type, may be used to fund participants’ basic everyday consumption needs, skills training programs and assets transfer until the poorest graduate from poverty and are ready to participate in an appropriate microfinance program. Secondly, the sequenced ICBM model is sharia compliant as it targets the poorest of the poor and complies with the transfer of ownership process. Further, this proposed ICBM model may develop linkages with existing government social assistance programs, particularly in the funding of basic needs, and employ volunteers to run regular client group meetings in order to reduce operational costs. A summary of the proposed model and its key elements are presented in Table 8.2.

Table 8.2. A proposed ICBM model

<table>
<thead>
<tr>
<th>Intervention</th>
<th>Objectives</th>
<th>Key elements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stipend for consumption</td>
<td>Stabilizing consumption, reduce vulnerability to malnutrition</td>
<td>Mentoring to motivate and build confidence of the participants</td>
</tr>
<tr>
<td>Developing saving habit</td>
<td>Personal financial planning and budgeting</td>
<td>Mentoring on financial planning</td>
</tr>
<tr>
<td>Skills enhancement training</td>
<td>Providing sufficient skills</td>
<td>Mentoring on business planning</td>
</tr>
<tr>
<td>Asset transfer</td>
<td>Initiating income generating activities</td>
<td>Ongoing support and coaching</td>
</tr>
<tr>
<td></td>
<td>Developing cottage industry/community industry</td>
<td></td>
</tr>
</tbody>
</table>

Source: Adapted from the poverty graduation model of the CGAP
To continue the sequential process of the client’s preparatory program, *zakat* institutions should develop partnerships with existing Islamic microfinance institutions in order to provide microloans for participants. There are two possible alternative forms of partnerships between Islamic charity institutions and commercial microfinance institutions. The first form is represented by those *zakat* organizations that act as client providers, whereby ICBM program graduates can be recruited as clients of commercial microfinance institutions. This form of partnership provides benefits for both clients and commercial microfinance institutions in the sense that clients can take advantage of access to longer-term poverty alleviation support, while commercial microfinance can recruit a ‘microenterprise ready’ client prepared by an ICBM institution.

The second form of partnership involves the development of an integrated institution, comprised of an Islamic charity funded institution and a commercially funded microfinance institution, as evidenced in a BMT model. Although this partnership model has been suggested as a sustainable model (Ashraf and Hassan, 2012), the implementation of an integrated institution is not straightforward as it embraces different culture and mission. It requires a strong institutional commitment to always balancing both social and commercial functions.

ICBM demonstrates significantly different characteristics from those of existing microfinance providers in Indonesia. In this case, the major role of the ICBM microfinance sector is to offer poverty alleviation intervention strategies that have potential to facilitate the poor’s participation in society’s financial system. Therefore, the research findings and analysis reported in this thesis strongly supports the development of ICBM into Indonesia microfinance regulatory system in order to enhance financial inclusion in Indonesia.
8.6. Conclusion

This chapter drew on the evaluation of the case study ICBM institutions’ BQB, BMB and BMMI achievement of the dual ICBM objectives: sustainability and outreach. The study found that the operationalization, or implementation of existing models are fraught with institutional sustainability and outreach challenges. This chapter discussed key factors to achieve a model of a sustainable, poverty outreach and sharia compliance ICBM in Indonesia. This study argues that ICBM should not provide microfinance service directly to the poor, rather developing poor capability to participate in microfinance. This chapter strongly suggested the inclusion of ICBM sector in the national strategy of financial inclusion in Indonesia. The next chapter will conclude the thesis.
Chapter 9
Conclusions

9.1. Introduction

At the heart of the research study reported in this thesis are research questions around the sustainability and outreach of the provision of Islamic charity based microfinance (ICBM) for the purpose of alleviating poverty amongst Indonesia’s poorest. This concluding chapter addresses these research questions through a reiteration of each chapter’s key findings. To begin, the research questions and objectives are revisited. This is followed by an overall summary of the study’s main findings. Informed by the research findings, the presentation of suggested future research directions conclude the thesis.

9.2. The research objectives

The reported research explored a type of microfinance funding source in Indonesia: Islamic charity based microfinance (ICBM). This particular microfinance provider utilizes Islamic charitable funds collected from zakat, shadaqa and waqf to provide financial and non-financial products and services to the poor using Islamic transaction schemes. The overarching aim of such funding arrangements is to alleviate poverty through the provision of initial capital for zakat recipients to start developing their own microbusinesses. Compared to other conventionally funded microfinance institutions that profit in part from loan interest payments, ICBM institutions do not profit from their diverse range of integrated interest-free loan schemes and client services offered to their financially vulnerable clients. Issues to do with the notions institutional sustainability and client outreach were of central interest in the research reported in this thesis.

The Islamic microfinance theoretical literature argues that Islamic charity provides benefits to microfinance institutions by reducing operational costs, reducing asymmetric
information, increasing institutional sustainability and increasing the participation of the poorest in the ICBM institutions’ program offerings through effective outreach strategies. This literature is seemingly silent in relation to at least two key questions: ‘what is the nexus between Islamic charity and microfinance?’ And ‘where is the empirical evidence base on which to base theoretical assertions about beneficial role of Islamic charitable institutions can play in the achievement of institutional sustainability and client outreach?

Informed by the literature reviewed, the study posed three research questions:

1. To what extent can Islamic charity be used in microfinance without compromising the inherent characteristics of Islamic charity?
2. To what extent can ICBM institutions be sustainable?
3. Is an ICBM institution able to include the poorest’s participation in microfinance?

With respect to the background context above, the research objectives are:

1. To examine the characteristics of Islamic charity and microfinance that enhance and constrain the ability of microfinance institutions to achieve institutional sustainability and client outreach.
2. To examine the institutional sustainability of ICBM
3. To examine the ability of ICBM to provide access to financial services for the specifically targeted outreach demographic
4. To propose a new model of ICBM that addresses financial inclusion in Indonesia

9.3. Chapter by chapter findings

**Chapter One** set out the research background by explicating both the potential of Islamic charity as a microfinance funding source and the rise of the Islamic charity sector as a participant in Indonesian microfinance initiatives. This chapter argued that the long history and the active presence of ICBM institutions in Indonesia offer
interesting and illustrative case study examples of the ICBM programs. The research questions presented in this chapter were informed by literature review insights into competing debates around the achievement of the dual objectives of microfinance, sustainability and outreach, and the role of Islamic microfinance and Islamic charity in achieving this dual objective. This chapter also briefly outlined the rationale for using case study as the overall research methodology and explained the significance of the study to the Islamic microfinance literature in its offering of empirical research insights into the integration of Islamic charity and microfinance and by proposing a sustainable and poverty focused ICBM model.

Chapter Two raised questions about the application of the Islamic finance concept to microfinance. The theory of microfinance and Islamic finance was discussed in an attempt to respond these questions. This chapter’s literature review illuminated the theoretical and practical links between microfinance and Islamic finance. The wide variety of Islamic transaction schemes evidenced in the literature were understood from the review to be applicable to microfinance. As an overall insight, the Islamic microfinance literatures suggest Islamic charity needs to be integrated into Islamic microfinance sector to enhance Islamic microfinance institutional capability in order to achieve both a high level of sustainability and broad inclusive outreach.

The discussion in Chapter Three centered on the integration of Islamic charity and microfinance. This discussion raised issues around the importance of tackling poverty and the potential role Islamic charity can play in reducing inequalities between the financially secure and the poor. Research shows that the alleviation of poverty and reductions in the rates of poverty in Islam cannot be effectively addressed by a direct and unconditional handing over of money to the poor. According the literature reviewed, and from the researcher’s standpoint, Islamic charity funds should be distributed within the context of providing opportunities for clients to build their capability to generate their own income through self-managed small business enterprises. From the research study findings, it is suggested that Islamic charity alone is unlikely to be sufficient to alleviate poverty unless the poor have viable supported opportunities to actively participate in a market based economy. One of the main reasons the microfinance sector is receiving increasing and significant attention from microfinance
scholars and the public is due to the capability of microfinance institutions to provide products and services that are well targeted to the poor. In this light, microfinance and Islamic charitable institutions share similar fundamental objectives in relation to the development and implementation of poverty alleviation strategies to facilitate the poor’s participation in the microfinance sector.

From the literature, it is evident that Islamic charity is a religious instrument embedded within a set of rules. This thesis discussed three types of charity known as zakat, shadaqa and waqf, their characteristics and their roles in poverty alleviation. The discussion pointed out that these types of Islamic charity demonstrate different characteristics and functions in their provision of microfinance funding (Haron et al., 2010, Obaidullah, 2008, Kaleem and Ahmed, 2009)).

To reiterate an earlier discussion of each of these types of Islamic funding, zakat as an obligatory charity has more specific sharia requirements regarding firstly, an obligation to pay zakat and secondly, the eligibility criteria of recipients of zakat (Qardhawi, 2009, Ahmed, 2004). In contrast to obligatory charity mechanisms, voluntary charitable donations are not subject to strict sharia regulations and can be distributed in more flexible ways.

Giving the specific guidance on how Islamic charity must be managed, insights from the literature highlighted the different roles played by each type of Islamic charity in the microfinance sector (Obaidullah, 2008, Ahmed, 2007, Kaleem and Ahmed, 2009, Zarka, 2011). A clear division of funds is necessary since zakat is intended specifically for the poor and the needy rather than for the other segments of eligible zakat recipients (Jassem, 2007). The model presented by Obaidullah (2008) and Kaleem and Ahmed (2009) used a combination of three types of charities to finance non-profit Islamic microfinance institutional operations. Zakat is used particularly for asset transfer and for education and skills training for the non-productive poor, while shadaqa and waqf are used to provide qard hassan loans for the productive poor. This particular theoretical model provides for a clear division of funding sources and sets out how funding is to be utilized.
The second intention of the literature review section presented in Chapter Three was to develop this study’s theoretical framework of institutional sustainability and client outreach. This framework was developed using two performance microfinance indicators suggested by Ledgerwood (1998): sustainability and outreach. In Ledgerwood’s study, sustainability is defined as the ability of a microfinance institution to cover its operational and financial costs. This definition of sustainability implies that microfinance institutions cannot depend on ongoing donor funding; rather they have to generate sufficient revenue from their operations to cover such costs. However, Ledgerwood’s sustainability definition cannot be readily adopted by ICBM institutions as they are totally dependent on Islamic charitable funding to cover all operating costs. ICBM institutions demonstrate similar characteristics to non-profit organizations, particularly in relation to the ways in which they utilize donor funds to achieve a specific mission.

This chapter reported literature findings that the achievement of sustainability in the non-profit microfinance sector is influenced by the capability of an institution to generate reliable funding resources and keep operating costs at a minimum. The literature reviewed informed that several elements are understood to play a role in the achievement of ICBM institutional sustainability: the types and sources of funding, efforts to innovate institutional products and services, the availability of community support, institutional accountability, loan repayment rates, operating costs components and sharia compliance obligations.

The second performance indicator of the microfinance sector is the extent to which ICBM institutions achieve broad and inclusive outreach. Outreach is defined as the ability of the institution to provide services to the poor (Ledgerwood, 1998). As earlier discussed, outreach becomes an issue in microfinance research as many microfinance institutions are being criticized for focusing more on financially secure clients at the expense of the poorest of the poor, in order to achieve financial sustainability. This thesis argument maintains that an ICBM reliant on Islamic charitable funds as the primary source of funds should focus on the poor and the poorest in society.
Chapter Four provided a logic of justification for the selected methodology. The research reported in this thesis adopted a case study methodological approach. This approach was understood to be appropriate to the research questions being explored and their associated research objectives that called for an analysis of three selected ICBM institutions and their unique economic and sociocultural contexts. Specific research methods used within the case study approach have the potential to generate the types of data required to respond to the research questions. In this study, a large scale survey, unstructured interviews and observation methods generated primary data. Secondary data were obtained from a document analysis of publications sourced from Bank Indonesia, the Indonesian Statistical Bureau and the Mix Market. Data collected from the interviews and document analyses were used to respond to the research questions focused on institutional sustainability. In addition, outreach related data was analyzed using document analysis techniques, descriptive analysis, poverty level analysis and the application of a binomial logit regression model.

The thesis presented the background to and context of the Islamic microfinance and ICBM sectors in Indonesia in Chapter Five. In locating the case study institutions in this context, the chapter pointed out that Islamic microfinance in Indonesia is delivered by four types of institutions: Islamic commercial banks, Islamic rural banks, Islamic financial cooperatives and ICBM. These institutions provide different products and services to differently targeted clients. The chapter discussion spotlighted that Islamic commercial banks, rural banks and Islamic cooperatives enjoy sufficient government regulatory support, while ICBM sector operates in an unregulated economic environment. The discussion also indicated that Islamic commercial banks and rural banks serve predominantly non-poor clients, while Islamic cooperatives and ICBM institutions penetrate the community’s lower income level demographic. These findings suggested that ICBM institutions need to reach out more broadly to this financially disenfranchised demographic society and play a more vigorous role in expanding their practices to include this neglected and financially vulnerable population sector. This chapter also introduced the three institutions included in the case study: Baitul Qiradh Baznas (BQB), Baitul maal Muamalat Indonesia (BMMI), and Baitul Maal Beringharjo (BMB).
Drawing from the interview data and document analyses, Chapter Six presented the study’s empirical findings on ICBM’s institutional sustainability. Framed around the sustainability elements listed in Chapter Three, a summary of the sustainability evaluation now follows:

1. The three case institutions reported an increase in the amount of funds collected from 2010 to 2011. The funding composition of ICBM institutions shows that in zakat organizations, more than 75% of funds are derived from compulsory donations or zakat, whilst funding generated from other sources are very limited. The opposite occurs in the case of BMB where most of the funds generated are derived from Islamic voluntary donations.
2. The three case study institutions implemented innovative ideas related to fundraising, product development, and donor relationships that have the potential to strengthen institutional sustainability.
3. Community support was limited in the case of zakat organizations; in contrast to the high level of community support enjoyed by BMB.
4. The zakat funded organizations demonstrated efforts to maintain institutional accountability by providing public access to their financial reports. Yet, this accountability measure was not evident in the case of BMB.
5. In the case of zakat funded organizations, there was evidence of a low rate of loan repayments around issues to do with a lack of loan monitoring staff and public perceptions of zakat as direct charity.
6. The zakat funded organizations evidenced a dilemma in which high operating costs may exceed the limited budget allocated to cover these.
7. Complexities in meeting sharia compliance related to the transfer of ownership of assets were evident in zakat organizations.

To better understand the complex underlying issues around achieving institutional sustainability, the study looked more closely at relationships between the elements of institutional sustainability. There are several findings:

1. The capability of ICBM institutions to increase the amount of Islamic charity collected is largely due to their innovative fundraising ideas and program design
in concert with greater transparency around and accountability for the management of funds collection and distribution.

2. Local ICBM institutions, as evidenced by BMB, have a greater capability to attract community support and in so doing, reduce institutional operating costs. As a consequence the likelihood of achieving a high level of institutional sustainability may be increased.

3. ICBM institutions that are highly dependent on *zakat*, in this case BMMI and BQB, face greater challenges in meeting sharia compliance obligations and in changing public perceptions. These challenges are understood to be behind the low rates of loan repayment in ICBM institutions. If not adequately addressed, these challenges threaten institutional sustainability.

4. Overall, ICBM institutions in Indonesia lack any formal regulatory support that could otherwise provide clear guidance on the management and governance of ICBM funds and institutional products and services. This lack of formal regulatory support may limit the ability of the institutions to mobilize savings and attract other funding sources.

**Chapter Seven** presented findings related to ICBM’s capability in reaching a specific level of outreach. These findings were derived from the survey questionnaire data and interview data directly aligned with the research question: ‘Is an ICBM institution able to include the poorest’s participation in microfinance?’ In an attempt to respond that question, the characteristics of the clients and the non-clients groups were compared. The summary of the findings is outlined below:

1. The descriptive analysis of client’s demographical profiles shows that BQB’s clients seem to fit a more financially vulnerable demographic profiles compared to the non-client group in terms of age, length of education and household head gender. By contrast, the clients of BMMI and BMB have similar demographic profiles to the non-client group along most variables.

2. Income and expenditure profiles also show a similar picture to the demographic data, whereby BQB’s clients are positioned at lower income and expenditure levels than the non-client group; while BMMI and BMB have selected clients who are at similar levels of income and expenditure to the non-client group.
3. The investigation into commercial microfinance providers' savings and loans products and services shows that many clients of ICBMs are active savers and that there is a high savings account participation rate in the commercial financial sector. However, the majority of ICBM's clients participates only in ICBM loan programs, and has limited participation in the commercial savings and loans market.

4. The clients of the three selected ICBM institutions face challenges in relation to having limited businessrelated skills and health concerns that might limit their capacity to operate an ICBM funded microenterprise.

5. The case study institutions’ clients participated to a limited extent in other social assistance programs.

Overall, the document analysis of ICBM’s average loan balance per borrower data suggested that the case study ICBM institutions demonstrated the lowest average loan balance per borrower compared to the four other types of microfinance institutions. This finding indicated that ICBM institutions target clients at the lowest poverty levels compared to other microfinance funding providers. However, this analysis could not provide any information about clients’ level of poverty that could be compared to those within the whole society.

Further poverty analyses were used a benchmark of the national food expenditure poverty line at $0.95 to investigate the poverty level of clients. The study found that a large percentage of both case study ICBM clients and non-client participants lived just above the poverty line. This finding indicated that many respondents in the study survey spend more on food than the national food expenditure poverty benchmark and as such cannot identified as poor. Additionally, to investigate the vulnerability of the study’s respondents to poverty, the benchmark figure for the national food expenditure poverty line was raised from $0.95 to $2. This analysis found that 79%, 94%, and 96% of the BMMI, BQB and BMB respondents respectively lie just below the $2 per day benchmark, with an average daily food expenditure of $1.17. The findings here suggested that as the respondents lived marginally above the poverty line, they could be identified as the financially vulnerable poor.
To provide more robust models for selecting eligible clients, the study employed a binomial logit regression model to measure the probability of a respondent being selected by the case study ICBM institutions as a client relative to not being selected as a client. Several variables such as prospective clients’ demographic profiles, income and expenditure information and issues around health and business skills were used as predictive variables of the client selection decision. The objective was to test whether clients and non-clients have significantly different baseline demographic and income characteristics. The overall findings from the application of the binomial logit regression model supported the descriptive analysis of the survey data in that compared to the other two case study ICBM institutions, BQB selected the more financially vulnerable clients than the non-client groups.

This thesis examined a number of reasons why the Indonesian ICBM sector is failing in its outreach to the poor. Three factors are understood to be at work to exclude the poor’s participation in this ICBM sector: inadequate program promotional strategies on the part of the ICBM institutions, exclusionary policies related to client selection, cultural barriers, and self-exclusion. In BMMI’s case, the institution’s requirement that firstly, clients be more involved with their local mosque and secondly, that prospective clients cannot be running an existing microenterprise, are understood as significant factors that unintentionally exclude the poor’s participation. In the case of BMB, it was argued that cultural barriers contributing to the poor’s self-exclusion were of greater significance than any institutional client selection policy shortcomings.

In general, the study found that selected ICBM institutions faced various challenges in achieving high levels of sustainability and outreach. Drawing on theoretical and empirical evidence, this thesis argued that Islamic charity constitutes an important source of microfinance funding. Islamic charity, particularly zakat has a limited role in microfinance. Given its inherent characteristics, zakat funding is most likely suitable in developing poverty intervention initiatives before clients begin to participate in the institution’s loan related microfinance activities. Evidence suggests that the poor should take advantage of programs designed to prepare them for their participation in such activities and that foster the development of clients’ self-confidence and financial literacy (Woolcock, 1999, Wright, 2000). This argument implies that zakat is unlikely to provide
qard hassan loans. The previously discussed issues around the negative public perception of zakat as ‘free money’ given directly to the poor, and the challenges inherent in meeting sharia compliance may constrain the effectiveness of using zakat funding for qard hassan loans.

The study grasped the potential for the ICBM sector to play a more significant and effective role in setting a more financial inclusive agenda for the poor in Indonesia. Therefore, this study proposes a new ICBM model as an alternative to the existing model, informed by the study’s identification of ICBM institutional operating strengths and weaknesses from both the study data and from ICBM document analysis. Given the arguments discussed above, Chapter Eight presented various strategies to achieve high levels of sustainability and more effective targeting to achieve specific outreach outcomes for the institutions. The strategies related to achieving sustainability can be summarized as below:

1. Increasing revenues by creating innovative fundraising campaigns that target middle class income earners, promoting the positive features of Islamic charity, enhancing cash waqf collection processes, and attracting larger corporate donations.
2. Adopting self-enterprise schemes by creating profit entities to support the institutions’ non-profit activities
3. Attracting community support in the form of volunteerism to reduce operational costs.
4. Reducing dependency on zakat funding by attracting other sources of charitable funding and integrating more closely with commercial microfinance.

In addition, the study proposed several more broadly inclusive strategies to increase poverty-focused outreach in the microfinance sector as detailed below:

1. The design of appropriate products and integrated services, the provision of weekly group support meetings, and education and training programs for the poor.
2. The reformulation of client selection eligibility criteria to remove exclusionary policy conditions related to prospective clients’ existing enterprises and to expectations that prospective clients be more involved in their local mosque.

3. The adoption of cultural values within institutional mentoring programs by using the local language, employing local staff and using local terms to identify, describe and explain the institution’s programs.

4. The creation of a national database of eligible zakat recipients.

5. The adoption of clear client targeting and communication strategies.

The thesis suggested that Islamic charity institutions’ roles are to provide sequential services to increase the capacity and capability of the poor, specifically in relation to meeting daily basic needs, developing and encouraging clients’ savings routines, providing education and business-related skills training, and providing productive assets. To continue these client’s preparatory programs, zakat institutions should develop partnerships with existing Islamic microfinance institutions in order to provide microloans for participants.

9.4. Future research directions

The use of Islamic charity as a source of microfinance funding is a new endeavor within Islamic microfinance discourse. Ever-louder ICBM debates raise questions deserving of further investigation. This study identified that major constraints on the poor’s fuller participation in the microfinance sector include cultural barriers and self-exclusion. It would be interesting to investigate whether these constraints are related to particular beliefs and values, or to a lack of financial literacy.

The first issue deserved further observation is the influence of patriarchal culture to women participation in microfinance in Indonesia. Drawing from the case study findings, the study identified that the participation of women clients in advanced program is limited. Further, from the observation of client’s demographic profile, the study also identified that that most of the clients’ households are headed by men. Issues around women participation in Islamic microfinance, patriarchy and other cultural related factors could be explored in future research.
 Secondly, further studies may also explore relationships between microfinance success, cultural barriers and financial literacy. Little is known about how cultural barriers may obstruct the poor from developing their financial literacy. Responses to these issues may open up broader and deeper understandings of the poor and their financial practices, motivations and hopes for the future that could inform further strategies related to the alleviation of poverty in Indonesia. Further research on the interconnections between financial literacy, financial exclusion and the role of ICBM in enhancing financial inclusion, may make a significant contribution to the development of inclusionary financial strategies in Indonesia.

The overall strategy on poverty reduction and social assistance in Indonesia seems less concerned about these financial education-related issues, with most of the poverty alleviation budget for social assistance currently going to income relief for the poor with only a relatively small amount used for promoting productive activities and human capital investment. This is the missing gap where ICBM has a role to narrow through its contribution to the overall strategy on financial inclusion. The government needs to support the development of ICBM by creating a regulatory environment around voluntary microfinance and productive zakat, as well as providing support for the collaboration and integration of ICBM into existing microfinance providers’ operations.

This thesis argues that the effective collection and distribution of Islamic charitable funds has the potential to play a significant role in expanding the financial inclusion of Indonesia’s poor and as a possible consequence, go some way to alleviate poverty. To successfully perform such a role, specific government regulatory support of ICBM practice is certainly needed.
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Appendix A

Microfinance Questionnaires

This questionnaire is prepared to answer my research question on how can Islamic religious teaching strengthen microfinance in achieving its their sustainability, outreach and impact to clients in Indonesia. I would be grateful if you could participate in this project by granting an interview in this topic. Thank you.

*Kuisioner ini digunakan untuk menjawab pertanyaan bagaimana prinsip-prinsip Islamic finance dapat meningkatkan peran microfinance dalam pengentasan kemiskinan di Indonesia.*

<table>
<thead>
<tr>
<th>Respondent</th>
<th>1 MFI clients (Klien MFI)</th>
<th>2 Non clients (Bukan klien MFI)</th>
</tr>
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<td>Respondent number (No responden)</td>
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<td>Name of the branch (Nama cabang)</td>
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<td>Name of the village (kelurahan/desa)</td>
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## I. INFORMATION OF HOUSEHOLD MEMBER

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<th>No</th>
<th>Name</th>
<th>Relationship with the household head</th>
<th>Sex</th>
<th>Marital Status</th>
<th>Age</th>
<th>Education</th>
<th>Main Occupation</th>
<th>Residence Status</th>
<th>NGO Membership</th>
<th>Disability</th>
<th>Severe Illness</th>
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<td>HHH</td>
<td>M:1</td>
<td>Single</td>
<td>Year</td>
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<td>Agriculture (own)</td>
<td>Permanent resident</td>
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<td>2</td>
<td>HHH wife/husband</td>
<td>F:2</td>
<td>Married</td>
<td>Month</td>
<td>Can read and write</td>
<td>Street vendor</td>
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<td>Son/daughter</td>
<td>2</td>
<td>Divorce</td>
<td>Status</td>
<td>Gone school but not passed any classes</td>
<td>Day labour</td>
<td>Temporary resident</td>
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<td>4</td>
<td>4</td>
<td>Father/Mother</td>
<td>3</td>
<td>Widow</td>
<td>Education</td>
<td>Passed elementary school (SD)</td>
<td>Small business</td>
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<td>5</td>
<td>Brother/Sister</td>
<td>4</td>
<td>Widower</td>
<td>10th</td>
<td>Passed secondary school (SMP)</td>
<td>Servant</td>
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<td>Son/daughter in law</td>
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<td>Passed tertiary school (SMA)</td>
<td>11th</td>
<td>Passed university degree</td>
<td>Driver</td>
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<td>Grand Son/daughter</td>
<td>6</td>
<td>Other</td>
<td>12th</td>
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<td>HH work</td>
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**3. Relationship with HHH**
- 2= HHH wife/husband
- 3= Son/daughter
- 4= Father/Mother
- 5= Brother/Sister
- 6= Son/daughter in law
- 7= Grand Son/daughter
- 8= Servant
- 9= Other

**7. Marital Status**
- 1= Single
- 2= Married
- 3= Divorce
- 4= Widow

**8. Education**
- 1= Illiterate
- 2= Can read and write
- 3= Gone school but not passed any classes
- 4= Passed elementary school (SD)
- 5= Passed secondary school (SMP)
- 6= Passed tertiary school (SMA)
- 7= Passed university degree

**11. Main Occupation**
- 1= Agriculture (Own)
- 2= Street vendor
- 3= Day labour
- 4= Small business
- 5= Servant
- 6= Fishing
- 7= Driver
- 8= HH work
- 9= Others

**10. Residence Status**
- 1= Permanent resident (living in the house for last 1 year)
- 2= Temporary resident

**12. Disability**
- 1= Blind
- 2= Deaf
- 3= Can not talk
- 4= Can not walk
- 5= Can not move hands
- 6= Mentally disabled
- 7= Others

**13. Severe Illness**
- 1= Yes
- 2= No
II. WELFARE AND INCOME GENERATION

a. Housing Information (Please circle the correct information)

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<th>Material of the house</th>
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<th>Present value of the house including land in Rupiah</th>
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<td><strong>Roof</strong></td>
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<td>1= own</td>
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<td>2= Bamboo</td>
<td>2= Ashes</td>
<td>2= rented</td>
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<td>3= Batako</td>
<td>3= Seng</td>
<td>3= sharing</td>
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<td>4= Wood</td>
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### Last one year income generation of the household member

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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### III. CONSUMPTION AND EXPENDITURES

a. Source of expenditures (tick the most appropriate answer)

<table>
<thead>
<tr>
<th>Name of goods</th>
<th>Source</th>
<th>Amount per month</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Purchase</td>
<td>Own production</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Relative</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Neighbors</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Government</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Zakat</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Borrowing</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Charity</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Other</td>
</tr>
</tbody>
</table>

- Fuel
- Clothes
- Household equipment
- Shoes/Slippers
- Education cost
- Health cost

b. Consumption detail on food on monthly basis

<table>
<thead>
<tr>
<th>Unit</th>
<th>Amount</th>
<th>Value</th>
<th>Source</th>
<th>Unit</th>
<th>Amount</th>
<th>Value</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rice</td>
<td></td>
<td></td>
<td></td>
<td>Rice</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cooking Oil</td>
<td></td>
<td></td>
<td></td>
<td>Cooking Oil</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vegetable</td>
<td></td>
<td></td>
<td></td>
<td>Vegetable</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Meat</td>
<td></td>
<td></td>
<td></td>
<td>Meat</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tahu/Tempe</td>
<td></td>
<td></td>
<td></td>
<td>Tahu/Tempe</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fish</td>
<td></td>
<td></td>
<td></td>
<td>Fish</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Milk</td>
<td></td>
<td></td>
<td></td>
<td>Milk</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fruits</td>
<td></td>
<td></td>
<td></td>
<td>Fruits</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Flour</td>
<td></td>
<td></td>
<td></td>
<td>Flour</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Spices</td>
<td></td>
<td></td>
<td></td>
<td>Spices</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sugar</td>
<td></td>
<td></td>
<td></td>
<td>Sugar</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tea/Coffee</td>
<td></td>
<td></td>
<td></td>
<td>Tea/Coffee</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Biscuits</td>
<td></td>
<td></td>
<td></td>
<td>Biscuits</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cigarette</td>
<td></td>
<td></td>
<td></td>
<td>Cigarette</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td></td>
<td></td>
<td></td>
<td>Others</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Unit: Gram/ Kilogram/ Number*
IV. LOAN AND SAVING INFORMATION

a. Loan Information

<table>
<thead>
<tr>
<th>Loan Information</th>
<th>Amount</th>
<th>Mortgage Against Loan</th>
<th>Types of Loan Repayment</th>
<th>How Often Do You Repay Loan on Time</th>
<th>Use of Loan</th>
</tr>
</thead>
<tbody>
<tr>
<td>number</td>
<td>Sources of Loan</td>
<td>Type of Loan</td>
<td>How often do you Use of loan</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td>1= along principal + interest in due time</td>
<td>1= Consumption</td>
</tr>
<tr>
<td>2</td>
<td></td>
<td></td>
<td></td>
<td>2= along interest and principal every month</td>
<td>2= Treatment</td>
</tr>
<tr>
<td>3</td>
<td></td>
<td></td>
<td></td>
<td>3= interest each month, but principal in due</td>
<td>3= Investment</td>
</tr>
<tr>
<td>4</td>
<td></td>
<td></td>
<td></td>
<td>4= others (specify...)</td>
<td>4= Asset Purchase</td>
</tr>
<tr>
<td>5</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>5= Working capital</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>6= Others (specify...)</td>
</tr>
</tbody>
</table>

2) Source of Loan:
1= BMMI
2= Bank (specify...)
3= BPR/BPRS
4= BMT/Koperasi
5= Relative
6= Friends
7= Neighbour
8= Shops
9= Others

3) Types of Loan:
1= Without interest
2= With interest
3= debt to shop
4= buying inventory for business in credit

5) Mortgage Against Loan:
1= Yes
2= No

6) Type of Loan Repayment:

7) How Often:
1= very often
2= often
3= not so often
4= never

8) Use of Loan:
1= Consumption
2= Treatment
3= Investment
4= Asset Purchase
5= Working capital
6= Others (specify...)
b. Saving information (Circle the most appropriate answer)

<table>
<thead>
<tr>
<th>Number</th>
<th>Source of saving</th>
<th>Type of saving</th>
<th>Amount of saving</th>
<th>Place of saving</th>
<th>Use of saving</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

2. Sources of saving 3. Type of saving 5. Place of saving 6. Use of saving

1= income 1= Cash 1= At home 1= accidental m
2= zakat 2= Jewelry 2= Bank 2= education
3= selling valuable asset 3= Land 3= BMT/Koperasi 3= business exp
4= family/neighbors 4= Cow/Goat 4= BPR/BPRS 4= special occa
5= others (specify) 5= Durable goods (television, fridge, 5= Others (specify... 5= others (spec
6= others

V. ZAKAT AND CHARITIES INFORMATION

<table>
<thead>
<tr>
<th>Number</th>
<th>Source of Zakat</th>
<th>Type of Zakat</th>
<th>Amount of zakat</th>
<th>Use of zakat</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Mustahik

<table>
<thead>
<tr>
<th>Number</th>
<th>Source of Zakat</th>
<th>Type of Zakat</th>
<th>Amount of zakat</th>
<th>Use of zakat</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Muzakki

2) Source of Zakat 3) Type of zakat 5) Use of zakat

1= Mosque 1= zakat fitrah 1= consumption
2= Lembaga Amil Zakat (Specify...) 2= zakat maal 2= working capital
3= Personal 3= infaq and shadaqah 3= investment
4= Government 4= treatment 4= special occasion
5= other (specify...) 5= others (specify...)
VI. UNDERSTANDING SYARIAH PRODUCT

<table>
<thead>
<tr>
<th>No</th>
<th>Questions</th>
<th>Strongly Agree</th>
<th>Agree</th>
<th>Neutral</th>
<th>Disagree</th>
<th>Strongly Disagree</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Becoming Islamic MFI client allows me to develop my own business</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Islamic MFI product is really suitable with my needs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Obtaining credit from commercial banks is difficult for me</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Obtaining credit from Islamic MFIs is difficult for me</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>I prefer profit loss sharing mechanism rather than fixed interest rate</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Charging interest rates is against my religious belief</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Islamic MFIs follow Islamic rules</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Islamic MFIs promotes fairness and justice</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>I go to the mosque more often after becoming an MFI client</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Islamic MFIs staff is more helpful than conventional bank staff</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>As Muslim, I have to obtain credit and save in the Islamic institution rather than conventional institution</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>I don’t have to provide any collateral on my loan</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

VII. CLIENT’s PROBLEM

Do you face the problems related to:

(Yes=1/ No=0)

<table>
<thead>
<tr>
<th>No</th>
<th>Problem</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Lack of management skill</td>
</tr>
<tr>
<td>2</td>
<td>Lack of technical skill</td>
</tr>
<tr>
<td>3</td>
<td>Illiterate</td>
</tr>
<tr>
<td>4</td>
<td>Innumerate</td>
</tr>
<tr>
<td>5</td>
<td>Health problem</td>
</tr>
<tr>
<td>6</td>
<td>Other</td>
</tr>
<tr>
<td></td>
<td>(specify)</td>
</tr>
</tbody>
</table>
Appendix B

Interview Guidance Lists

Date/Place:

<table>
<thead>
<tr>
<th>Name of the Institution</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Address</td>
<td></td>
</tr>
<tr>
<td>City</td>
<td></td>
</tr>
<tr>
<td>Province</td>
<td></td>
</tr>
<tr>
<td>Telephone</td>
<td></td>
</tr>
<tr>
<td>Fax</td>
<td></td>
</tr>
<tr>
<td>Email</td>
<td></td>
</tr>
<tr>
<td>Contact Person</td>
<td></td>
</tr>
<tr>
<td>Phone/email</td>
<td></td>
</tr>
</tbody>
</table>

1. General Data
   a. Year of establishment
   b. History and major changes
   c. Mission and Vision statement
   d. Organizational structure
      a. Board of Director and Management (autonomy, lending limits, specific roles)

2. Affiliations
   a. Affiliations
   b. Have your institutions received financial capital/subsidy from:
      a. International donor/funding agency (yes/no)……who?
      b. Government…..(yes/no)….who?…………………………..how much……………..?
      c. Religious organization (yes/no)……..who?……how much…?
      d. NGO (yes/no)…..who?...how much…?
      e. Other subsidy……

3. Delivery System
   a. Number of branches
   b. Number of affiliated mosques
   c. Number of staff
   d. Number of loan officers
   e. Services radius
   f. Number of areas covered
   g. Number of cities
   h. Number of province

4. Staffs:
   a. Type of roles
   b. Professional qualifications
   c. Incentive schemes

5. Market
   a. Describe target market
   b. Total active clients
   c. Client’s composition based on profession
d. Percent women  
e. Income structure of clients (below the poverty line)  
f. What is the marketing strategy?  
g. How to communicate the programs?

6. Services  
a. Financial Services  
   i. Types of Loan  
      1. Outstanding loan  
      2. Number of loan account  
      3. Average loan size  
      4. Number of active borrower  
      5. Average loan processing time  
      6. Loan Guarantee Mechanism  
   ii. Types of Saving  
      1. Voluntary/Compulsory?  
      2. Minimum saving?  
      3. Any Financial return?  
      4. Can it to be withdrawn?  
      5. Is it linked to loan?  
   iii. Other non-financial services  
      1. Types?  
      2. Can anyone access this?  
   iv. Mentoring  
      1. Process of mentoring  
      2. Subjects of mentoring

7. Innovation  
a. What area of innovation taken by the institution?  
b. The importance of innovation

8. Economic Performance  
a. Overall overview  
b. Source of funds

<table>
<thead>
<tr>
<th>Sources of funds</th>
<th>%</th>
<th>Cost of capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zakat</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Infaq</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shadaqa</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Waqf</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commercial source of funds</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Donor/subsidy</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

c. Any cash flow challenges occurred  
d. Policy on Bad debt and enforcement strategy to reduce bad debt  
e. Strategies to compete in the market