

# Challenges Sharia Microfinance Institutions: Evidence from Indonesia

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**Abstract**—Microfinance institutions and Islamic microfinance institutions that do not have a body would be transformed into cooperatives (Coop) or shareholder firms (SHFs) company under the act No.1 of 2013 (UU No.1 Tahun 2013) regarding microfinance institutions. One of Islamic microfinance institutions for being Baitul Mal Wa Tamwil (BMT) that currently a majority of non-governmental organizations are required to transform to become more professional, and should be answer the challenge in the future. In this literature review there are some challenges for BMT to be transformed and can be exist in future. The challenges of BMT, are what the microfinance market that also relevant to the Islamic perspective will be needed in future. This literature review is limited by three questions, (i) What is the purpose of BMT?, (ii) What are the challenges of BMT in the future?, (iii) What are the advantages BMT incorporated in?.

**Keywords:** *Islamic micro finance, the act No.1 of 2013 regarding microfinance institutions, Baitul Mal Wa Tamwil, Transformation, Microfinance challenges, Islamic perspective.*

JEL classification: G02, G14, G21

## 1. INTRODUCTION

### 1.1. Background

Issuance the Act (UU) No.1 Year 2013 on microfinance institutions will certainly have an impact on changes in the shape and condition of Indonesian microfinance institutions including Islamic microfinance institutions in the future, because the Act requires microfinance institutions have legal entities or shareholder firm and also the operations of microfinance institutions will be supervised by the financial services authority. Currently there are still many microfinance institutions, particularly Islamic microfinance institutions that do not have a legal entity, IE Baitul Mal Wa Tamwil (BMT) which amount 60% of the total BMT (Republika Online.com, December 15, 2010). The number of BMT to June 2012 is estimated at 5,500 units (Republika Online.com, June 28, 2012), and if 60% of BMT has not been incorporated in the amounted to 3,300 units and 2,200 units remaining BMT incorporated cooperative.

Based on the goal of microfinance institutions have the function of providing financial services to low income communities not served by banks (unbankable) (Armendariz

and Labie, 2011). While the definition of microfinance is to provide financial services to people who have limited access to banking services. The financial services are; financing or credit, savings, remittances and insurance (Karlan and Golberg, 2011). However, the implementation and operation of microfinance institutions get the challenge of mismatch between the needs of low-income people with products offered by microfinance institutions (Armendariz and Labie, 2011). Besides that microfinance institutions should protect all clients (savers) to run its operations based on prudential principles by Christen et al. (2003).

Under these conditions, how can Islamic microfinance institutions can meet the challenges of mismatch and protect all its customers in order to implement the Act No.1 of 2013?.

### 1.2. Limitation of Research

A lot of BMT is still not incorporated in. Based on Act No. 1 of 2013, the BMT that does not have a legal entity shall be transformed into cooperatives or SHFs. Then the limitation of this study is how the transformation process BMT be incorporated in to meet the needs of low-income communities (the challenge of microfinance institutions) and in order to keep operations running the prudential principles.

### 1.3. Objectives and Contributions

Goals and contribution of this study is to provide input for Islamic microfinance institutions (BMT) in order to survive in the future. BMT is also expected to play an active role in creating wealth evenly throughout society by enforcing Sharia (Islamic law) in order to achieve the economic goals of Islam. Definition of the purpose of Islamic economics or maqashid Shari'ah is to create *maslahah Ummah* who became one of the important pillars of the economy and business in sharia. It is also narrated in a hadith by Musnad Shihab, Hadith no. 1234 as follows:

خَيْرُ النَّاسِ أَنْفَعُهُمْ لِلنَّاسِ

"The best man is the most useful for others."

## 2. RESEARCH METHODOLOGY

The research method is based on a qualitative research, The framework of this research is defined by research questions as follows:

- What is the purpose of BMT?
- What are the challenges of BMT in the future?
- What are the advantages BMT incorporated in?

## 3. ANALYSIS

### 3.1. The purpose of Islamic Microfinance Institutions

The Characteristics of microfinance institutions, there have two roles, the first function is related to financial (commercial) and second as a social function (Hudon, 2011). Microfinance institutions aim is not always to maximize profits (Copestake, et al., 2005) but its main purpose is to provide access services to low-income people who cannot be served by banks (Morduch, 1999).

BMT is micro-finance institutions that carry out activities based on Islamic principles. The main factor underlying the establishment of BMT is the desire to run an economic system that is based on the values and principles of Islamic justice which aims to distribute free from all forms of exploitation. In addition, the role and function of BMT is to develop human resources and to support micro and small entrepreneurs as well as a viable potential (Holloh, 2001). Roles and tasks BMT as follows:

- 1) Help identify needs and business opportunities.
- 2) Help plan and provide business consulting.
- 3) Mobilizing funds from the public.
- 4) Provide and facilitate access to financial services and marketing channels.
- 5) Disseminate information and provide training.

In connection with this, the BMT is a form of Islamic microfinance institutions whose roles and functions in accordance with khittah (basic concepts) microfinance institutions. Therefore the existence of BMT in the future is indispensable in improving the welfare of society.

### 3.2. Challenges for the Future BMT.

Developments and changes in the needs of low-income people is a challenge for BMT to fulfill. According Mersland and Storm (2012) microfinance institutions must innovate to meet the needs of low-income people so that the characteristics and objectives of microfinance institutions is maintained. However, microfinance institutions as a going concern entity must and should be transformed from idealism into business activities (commercial). The transformation is necessary because there are new clients who require access to affordable microfinance and microfinance institutions must maintain the continuity of its financial condition. Innovations required by microfinance institutions, according Mersland and Storm (2012) are as follows:

### 1) Making low-income communities as a target

Service banking products also provide finance or micro-credit services to low-income communities. However, there are still many low-income people who do not bankable but has potential and deserves to be given micro-finance. Based on that microfinance institutions can develop products according to the conditions in each area. In the Qur'an there are lots of explicit statements related to the poverty alleviation and the solutions to it, few of statements as follows:

- a. Al Insaan verse 8 says “And they give food in spite of love for it to the needy, the orphan, and the captive”.
- b. Al Baqarah verse 177 says “Righteousness is not that you turn your faces toward the east or the west, but [true] righteousness is [in] one who believes in Allah , the Last Day, the angels, the Book, and the prophets and gives wealth, in spite of love for it, to relatives, orphans, the needy, the traveler, those who ask [for help], and for freeing slaves; [and who] establishes prayer and gives zakah; [those who] fulfill their promise when they promise; and [those who] are patient in poverty and hardship and during battle. Those are the ones who have been true, and it is those who are the righteous”.
- c. Al Anfal verse 41 says And know that anything you obtain of war booty - then indeed, for Allah is one fifth of it and for the Messenger and for [his] near relatives and the orphans, the needy, and the [stranded] traveler, if you have believed in Allah and in that which We sent down to Our Servant on the day of criterion - the day when the two armies met. And Allah, over all things, is competent”.

Related to the issues of poverty alleviation in the Islam and the target from the Microfinance institutions to serve low income people, it's very relevant to become low income people as a target in an Islamic microfinance institution.

### 2) Making women as targets

Why women were subjected to micro-finance for the following matters:

- a. Gender equality, of course, in the teachings of Islam recognize the equal rights of men and women, regardless the nature of men and women have differences.
- b. Poverty alleviation, by empowering women to manage the household finances will add to the household income so that their household can live more prosperously.
- c. Efficiency, because the women who manage the finances and men who generate income (the division of the finance function in the household), then women can control their household expenses and arrange installment

payments to microfinance institutions in a timely manner.

According to Suratmi et. Al (2011) is based on of Islamic sharia either in the Qur'an or hadith, does not forbid women to work in the public domain. Men and women can work in both inside and outside the house and in any suitable field, which needs to be done in order to survive. But in Muslim developing countries, many women like and bound to stay at home. Moreover, there is no condition stating firmly that only men can be a public leader. There is some Quran verse that says men are more capable physically and intelligent than women.

However, if there are women as responsibilities to his family (children) feel more secure when they stay at home and avoid public activities. As well, if the daily lives of men are more opportunities than women in public activities (political, economic, etc.) That is not related to Islamic sharia, but because of the perception and habits of the local population. Based on these perceptions, women as target in the Islamic microfinance institution also very relevant to be implemented.

3) *Developed a variety of methods in channeling financing to low-income communities*

Identical micro financing by requiring collateral to clients who ask financing. It cannot be applied to microfinance institutions whose goal is to serve low-income people who in fact have limited collateral. Under these conditions, microfinance institutions need to innovate the methods of financing products and their features, such as group lending models are commonly called joint responsibility, provide financing with a short term (tenor), incentives, etc. These innovations must be adjusted to the characteristics of local communities.

4) *Doing organizational changes*

Microfinance institutions to provide guidance and supervision to the customers, but who is doing the coaching and supervision of microfinance institutions?. Initiatives and new paradigms non governmental Organizations (NGOs) in the world who care about poverty to transform the organization into a company whose shares are owned by the public (SHFs or cooperatives) as an example Prodem NGO in Bolivia changed to Banco Sol in 1992 (Von Pischke, 1996). The impact of these changes is to be more efficient because the organization runs its operations obedient (governance) that are caused by external guidance and supervision.

BMT as traditional organization, along with the growing number of BMT is followed by the emergence of various problems. This happens due to the absence of legal rules governing the protection and guarantee customer funds BMT. "We have grown a lot since BMT founded it easy. BMT alone is the domain of medium to

society. But in many cases that come his way as embezzlement of customer funds by the board.

Related to the issues of customers' protection in Islamic microfinance, the organizational changes to be more professional is very important to be carried out in Islamic microfinance.

5) *Looking for new sources of funding*

Microfinance institutions where it has been transformed into incorporated in may seek new sources of funding in a way; raise money by issuing shares, collect deposits from the public, and loans from other financial institutions. To serve low-income communities with a wide range, Islamic microfinance also require new funding not only from investors, donors, creditors, but also Islamic microfinance institutions have the opportunity to distribute zakat to the poor according to the criteria of sharia law.

6) *Environmentally friendly*

The originality of microfinance objective, it's to achieve the double bottom line. That is mean microfinance institutions are mindful not only about financial performance, but also by social indicators. Econometric analysis is used to assess financial performance, and guidance is provided for extending the analysis of social performance indicators or MFIs have a double aspect: financial and not-for-profit. It is, therefore, appropriate to assess their performance by means, not only of financial ratios, but also by means of social indicators. (Frank, 2008; Armendariz and Labie, 2011; Hudon, 2011; Stuart, 2011; Balkenhol and Hudon, 2011; Cinca et al, 2011). But why should microfinance should concern in environmental bottom line? Allet (2013) mention the clients of MFIs should be responsible for climate change because they have an impact on the environment.

The clients of MFIs have contributed in major environmental risk like chemical pollution, solid and liquid wastes, pollution emissions, inefficient production processes (energy-consuming, waste-producing), and degradation of natural resources. Regarding this risky, there are environmental issues in the community, such as health and sanitary issues, economic consequences, risk of conflicts, increased vulnerability and food security. Associated in this condition the donors in MFIs and the experts in this field, believed MFIs has capacity to involve in environmental concern in their activities to be third bottom line or additional from the original MFIs objective double bottom line, the triple bottom line element that consist of financial performance, social performance and environmental performance (Copestake, 2007; Green Microfinance, 2007; Van Elteren, 2007; FMO, 2008; Schuite and Pater, 2008; Rippey, 2009; Agier and Szafarz 2013). We believe green microfinance activities will be significant contribute to anticipate the impact of climate change for livelihood, because of the small scale activities in developing countries has the

threat of environmental destruction (Allet, 2013), and MFIs as the institution directly contact with the grassroots community.

Addressing in this condition, the services of MFIs could be as intermediaries, and have the opportunity for the dissemination of environmental awareness-raising information (Hall et al, 2008; SEEP Network, 2008). In line with this issue, Kaushal et.al (2005) also mentions that microfinance has a positive impact on the environment, because of there is a positive link between access to micro credit and forest regeneration in 27 Indian villages.

In the sharia perspective, environmental friendly also as crucial issues, the Quran was mention about the human activity should be not harmful for the environment. The connection between the Qur'an and environmental issues as follow:

- a. Al-A'raf verses 56 says "And cause not corruption upon the earth after its reformation. And invoke Him in fear and aspiration. Indeed, the mercy of Allah is near to the doers of good".
- b. Ar-Ruum verses 41 says "Corruption has appeared throughout the land and the sea by [reason of] what the hands of people have earned so He may let them taste a part of [the consequence of] what they have done that perhaps they will return [to righteousness]".

Based on the issues mentioned above, the process of transformation of BMT shall consider what innovations are needed in accordance with the conditions and needs of the communities in which BMT operates.

### 3.3. *Advantages of BMT transformed into Incorporated*

Based microfinance policy report reveals that most say that the ownership of publicly owned institutions (cooperatives or SHFs) has many advantages over non-governmental organizations or non-governmental groups (NGOs / CBOs). NGOs weakness is less commercial and professional due to the absence of the owner who monitor management (Chavez and Gonzalez - Vega, 1994; Berenbach and Churchill, 1997; Greuning et al, 1998; . Staschen, 1999; Christen and Rosenberg, 2000; C - GAP, 2003; Holden et al, 2003; Jansson et al, 2004). The implicit message is that the benefits of microfinance institutions that are owned by the people can run its operations better and be able to access more funds to be more efficient than the NGOs.

This is also consistent with the concept of sharia (sharia Enterprise Theory) which has a social responsibility. According Sudarma et.al (2010) social responsibility disclosure in Islamic entity is as follows:

- 1) Disclosure of social responsibility is a form of accountability to God and man intended to derive legitimacy from God as the ultimate goal.
- 2) Social responsibility disclosure must have a purpose as a means of providing information to all stakeholders (direct, indirect and natural) in relation to how far the agency has

fulfilled its obligations to all stakeholders. It is as part of efforts to meet accountability for human.

- 3) The existence of social responsibility disclosure is mandatory, views of Islamic microfinance institutions function as an instrument to realize the objectives of Shariah. Social responsibility reports would be a report that will complement the interests of all parties that have been neglected in modern accounting systems.
- 4) Social responsibility disclosure must include the material and spiritual dimensions associated with the interests of all stakeholders.
- 5) Consideration of the public interest (mashlahah) will be the basis of the disclosure.
- 6) Social responsibility disclosure should contain qualitative and quantitative information.

Based on the above, the concept of Islamic financial institutions also supports transparency, which led the organization to be more efficient because the management of BMT will receive guidance and direct supervision by the stakeholders, which consists of: the government, the owners, the public, etc.

## 4. CONCLUSIONS AND RECOMMENDATIONS

### 4.1. *Conclusions*

Based on the results of the qualitative analysis concluded the following matters:

- 1) Issuance of act No. 1 of 2013 on microfinance institutions has a positive impact on microfinance institutions and in particular for the BMT is currently incorporated in.
- 2) The positive impact of BMT is more professional and efficient in carrying out its operation.
- 3) BMT as Islamic microfinance institutions that have a social and commercial purposes must be able to transform to adjust to the needs of the community in the future.
- 4) BMT is an Islamic microfinance institutions that are characteristic of the Indonesian nation and not exclusive, open to the whole Ummah not just Muslim Ummah.
- 5) The Government shall support and supervise the existence of BMT in order to succeed the poverty alleviation program.
- 6) With the guidance and supervision of the interested parties, the BMT is gradually implementing prudential principles. Under these conditions, the safety of the public or customers in financial transactions in BMT protected.
- 7) Improve the reputation of BMT in the country and even on an international scale, if the transformation process had a positive impact on economic growth and poverty reduction.

#### 4.2. Recommendations

All stakeholders associated with this change must be mutually supportive for the good of humanity, so that the managers of BMT are not incorporated in does not have a prejudice against the issuance of act no. 1 In 2013, while government officials associated with the administration of the establishment and operation licenses provide a convenience (cost and bureaucracy), as well as the guidance and supervision of the presence of those who are competent in their field.

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