The Dynamic Role and Performance of *Baitul Maal Wat Tamwil:* Islamic Community-Based Microfinance in Central Java

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ABSTRACT

Baitul Maal Wat Tamwil (BMT) is a community-based and cooperative microfinance approach, and combines economic and socio-religious objectives in providing financial services to poor people and helping the needy participate in a dynamic Muslim society. The study objective is to examine the development of the BMT sector in Yogyakarta and in particular to assess the role and performance of and assesses the extent to which the BMTs' philosophy and modus operandi is sustainable in achieving the dual missions of poverty alleviation following Islamic principles. This study addresses research questions of how and what role of the BMT institutions, as the Islamic microfinance model in the Javanese Muslim community, and to what extent the BMT sector is sustainable.

The study uses a mixed-method research technique in which qualitative and quantitative methodologies are triangulated in order to understand how BMTs operate and integrate into the local community and economy. In addition, to capture the complexity and dynamics of the BMT phenomenon, the study design is longitudinal, covering three consecutive field studies from 2008 to 2010. To assess their performance, the study selected 28 BMTs from the BMT Apex institution membership and grouped them into three clusters based on size of assets, longevity and location.

The study found that BMTs have developed a capacity to perform economic development and socio-religious empowerment functions. However, the dual missions pose a dilemma for BMTs: how to differentiate their role as faith-based microfinance institutions from their socio-religious mission. The research also demonstrates that the BMT sector in the region has sustained its operations. However, the thesis argues that there is no relationship between longevity and the BMTs' business development. Instead,the location of BMTs significantly influenced the BMTs' asset growth and profitability. The most favourable BMTs environment is in traditional markets, business centres and densely populated residential areas in and surrounding Yogyakarta. Overall, the majority of BMTs achieve better operational and financial sustainability through larger economies of scale and greater integration with the dual banking and microfinance markets.

STUDENT DECLARATION

I, Mohamad Nazirwan, declare that the PhD thesis entitled 'The Dynamic Role and Performance of *BaitulMaalWatTamwil:* Islamic Community-Based Microfinance in Central Java' is no more than 100,000 words in length including quotes and exclusive of tables, figures, appendices, bibliography, references and footnotes. This thesis contains no material that has been submitted previously, in whole or in part, for the award of any other academic degree or diploma. Except where otherwise indicated, this thesis is my own work.

Signature Date 9 February 2015

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Islam is a transformative religion that strongly urges Muslims to perform better in many aspects of human life. As a part of my journey to accomplish my objective as a good Muslim, this thesis is a manifestation of a continuous learning process to develop my understanding about the multiple dimensions of microfinance, especially to satisfy my curiosity to explore the nexus of Islamic religious teachings in alleviating poverty with the ways Muslims engage in economic activities, especially banking, finance, and microfinance.

After conducting research over more than three years (2008–2011), inevitably my horizons toward faith-based microfinance have been broadened. My understanding of Islamic teachings has been enhanced, especially concerning the triangle of morals, knowledge and ritual as integrated tools in dealing with the economic and social problems in the community.

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GLOSSARY

Abbreviations

ABSINDO	Asosiasi BMT Indonesia (BMT Association)
ADB	Asian Development Bank
AGM	annual general meeting
APBN	AnggaranPenerimaandanBelanja Negara (National Budget)
API	ArsitekturPerbankan Indonesia (Indonesian Banking Architecture)
ATM	automatic teller machine
BAPPEDA	BadanPerencanaan Pembangunan Daerah (Local Development Planning Agency)
BASN	BadanArtitraseSyariahNasional (Islamic Arbitrate Council)
BAZNAS	BadanAmil Zakat Nasional (National Islamic Philanthropic Fund Collector)
BIMAS	BimbinganMassal (Mass Guidance)
BKD	BadanKreditDesa (Village Credit Body)
BKKBN	BadanKoordinasiKeluargaBerencanaNasional (National Planning Coordinating Institution)
BMT	BaitulMaalWatTamwil (Islamic Community-Based Microfinance)
BMTC	BMT center
BI	Bank Indonesia (Indonesia Central Bank)
BKK	BadanKreditKecamatan (Sub-district credit institution)
BPD	Bank Pembangunan Daerah (Regional Development Bank)
BPS	Biro PusatStatistik (Central Statistical Bureau)
BPR	Bank Perkreditan Rakyat (Rural Bank)
BPRS	Bank Pembiayaan Rakyat Syariah (Islamic Rural Bank)
BUMN	Badan Usaha Milik Negara (State-owned company)
BUS	Bank UmumSyariah (Islamic Commercial Bank)
BWTP	Banking With the Poor
CAMEL	Capital Adequacy, Asset Quality, Management, Earnings, Liquidity

CAR	capital adequacy ratio
CDP	Corps DakwahPedesaan (Rural Preaching Corps)
CGAP	Consultative Group to Assist the Poor
COF	cost of funds
CSR	corporate social responsibility
DBSKUKM	Dana Bergulir Sharia (Islamic Revolving Fund)
DDF	DompetDhuafa foundation
DISPERINDAGKOP	DinasPerindustrian, PerdagangandanKoperasi (Local Industry, Trade and Cooperative Agency)
DIY	Daerah Istimewa Yogyakarta (Special Region of Yogyakarta)
DPS	DewanPengawasSyariah (Syariah Supervisory Board)
DSN	DewanSyariahNasional (National Syariah Council)
FDR	financing deposit ratio
FGD	focus group discussion
FSS	financial self sufficiency
GDP	gross domestic product
GDRP	gross domestic regional product
HDI	human development index
ICMI	IkatanCendekiawan Muslim Indonesia (Islamic Intellectual Association)
IDB	Islamic Development Bank
IDR	Indonesia currency (rupiah)
IDT	*InpresDesaTertinggal* (Edict on Disadvantaged Villages)
IFC	International Finance Corporation
INKOPSYAH	IndukKoperasiSyariah (Apex Islamic Cooperative)
IRTI	Islamic Research and Training Institute
JPS	*JaringPengamanSosial* (social safety net)
KSP	KoperasiSimpanPinjam (Loan and Saving Cooperative)
KUBE	Kelompok Usaha Bersama (Collective Business Group)
LAZIS	LembagaAmil Zakat InfakSedekah (Islamic Philanthropic Fund Collector)
LDR	loan-to-deposit ratio

LPDB	LembagaPengelola Dana Bergulir (Revolving Fund Institution)
LPS	LembagaPenjaminSimapanan (Deposit Insurance Institution)
KIK	*KreditInvestasi Kecil* (Small investment loan)
KJKS	KoperasiJasaKeuanganSyariah (Islamic Cooperative Microfinance)
KMKP	*Kredit Modal KerjaPermanen* (working capital loan)
KOPDIT	*KoperasiKredit* (credit union)
KS	*Keluarga Sejahtera* (welfare family)
KUD	*Koperasi Unit Desa* (village cooperative)
KUK	*Kredit Usaha Kecil* (small enterprise credit)
KUR	*Kredit Usaha Rakyat* (people's business loan)
LDKP	Lembaga Dana danKreditPedesaan (Rural Saving and Loan Institution)
LPD	LembagaPerkreditanDesa (Village Credit Institution)
LPN	LembagaPitihNagari (rural credit institution in West Sumatra)
MCRIL	Microfinance Rating Company
MENEGKOP	Kementerian Negara Koperasi (Cooperative Ministerial Office)
MICRORATE	Microfinance Rating Company
MISKAT	Microfinance BerbasisMasyarakat (community-based microfinance program)
MSME	micro, small and medium enterprise
MUI	MajelisUlama Indonesia (Indonesia Cleric Council)
NGO	non-government organization
NPF	non-performing financing
NPL	non-performing loan
ONH	OngkosNaik Haji (Pilgrim Fund)
OSS	operational self sufficiency
PBMT	Permodalan BMT (BMT Capital)
PEARLS	Protection, Effective Financial Structure, Asset Quality, Rates of Return and Costs, Liquidity and Signs of Growth

PHBK	Program Hubungan Bank danKelompokSosialMasyarakat (linkage program between bank and community group)
PINBUK	PusatInkubasi Usaha Kecil (Center for Small Business Incubation)
PLS	profit and loss sharing system
PNM	PermodalanNasionalMadani (state-owned company)
PNPM-MANDIRI	Program NasionalPemberdayaanMasyarakatMandiri (National Program on People Empowerment)
PUAS	*PasarUangAntar Bank Syariah* (Islamic money market)
PUSKOPSYAH	PusatKoperasiSyariah (Apex Islamic cooperative)
ROA	return on assets
ROEA	return on earning assets
SBI	Sertifikat Bank Indonesia (the Central Bank Investment Certificate published by Bank Indonesia)
SME	Small and Medium Enterprise
SUP	Surat UtangPemerintah (Government bond)
SWBI	SertifikatWadiah Bank Indonesia (Central Bank Certificate)
UMKM	*Usaha Mikro Kecil danMenengah* (micro, small and medium enterprise)
UNDP	United Nations Development Program
USD	United States Dollar
USP	Unit SimpanPinjam (Unit of Loan and Saving Cooperative)
UUS	Unit Usaha Syariah (Unit of Islamic Commercial Bank)
WOCCU	World Council of Credit UnionsInc
ZIS	Zakat InfakSedekah (Islamic Philanthropic Fund)

Arabic Terminology

Ahadith Al-Bukhari	The Prophetic traditions that have been reported and documented in Al-Bukhari.
Al Wadiah	current account
Amanah	honest or trust
Amil	A person who work in administering and managing matters related to *zakah*, such as an officer and staff member appointed by the employer to manage matters related to *zakah* collection
Aqidah	creed that every Muslim must belief in Allah and the Prophets, and dogma of Islam teachings
BaitulMaal	philanthropic institution
BaitulTamwil	financial institution
Darurah	abnormal condition which a Muslim should find an alternative solution in order to solve the problem even if the solution could breach the *sharia*
Dua	asking blessing from the God (Allah)
Gharar	uncertainty, a future situation that cannot be predicted or unknown
Fatwa	non-binding legal opinion or interpretation regarding Islamic teachings that released by a qualified jurist or *Sharia* council
Faqir	a poor or needy person
Hablumminalah	rituals to maintain direct relationship with God for example daily praying
Hablumminannas	maintain relationship with other Muslim and other person regardless his/her religion
Hadist	A tradition or the collection of the traditions of Prophet Muhammad, which includes his words and deeds, and his tacit approval of what was said or done in his presence.
Haram	relating to prohibited acts, foods, etc.
Ied al fitr	a celebration of glorious moment after completing the fasting season in *Ramadan*and perform special congregational

	prayers *salah al-eid*. Many Muslims recite a declaration of faith (*takbir*), on the way to the prayer ground and give special charitable donation (*zakah al-fitr)*.
Ied al adha	a day commemorates Prophet Ibrahim's willingness to sacrifice his son (Prophet Ismail) to God which Muslim sacrifices of livestock such as cattle, goats, camels, buffalos,and also this moment marks the end of the Hajj pilgrimage to Mecca
Ijarah	leasing contract
Infaq	voluntary charity that is given without any expectation of reward or return
Miskin	person who does not have enough to meet his/her daily needs
Muallafat al-qulub	This is a person who is inclined to be close to Islam, such as a newly revert who has to give up his/her property and family ties. The amount is given from *zakah* is hoped to strengthen his/her faith and creates a sense of belonging among Muslim
Muamalah	Islamic teachings that rule relationship among persons in socioeconomic matters
Mudarabah	partnership between financial institution or bank and client through profit and loss sharing mechanism
Mudharib	business operator
Murabahah	trade transaction between financial institution or bank and client based on price mark-up mechanism
Musaraka	partnership between financial institution or bank and client through ownership of specific project or assets
Muzakki	a qualified Muslim that must pay part of his/her wealth as compulsory *zakah*
Musthahik	beneficiary of compulsory philanthropic (*zakah*)
Nisab	Threshold annual income or wealth that must be donated for compulsory philanthropy (*zakah*)
QardHasan	benevolent loan
Rabb al Mal	investor
Rahn	physical collateral against a debt

Ramadhan	a period during which Muslims must fast during the day
Riba	increase, usury practices in financial and trade transactions, such as charging interest and other illicit transactions
Ruhiyah	spiritual matter
Sadaqah	voluntary charity
Salah	ritual praying
Sharia	Islamic law that is used in regulating various aspects of Muslim life in the community
Sukuk	Islamic equivalent of bond that is traded in the capital market. *It* grants the investor a share of an asset, along with the commensurate cash flows and risk.
Surah	chapter of the Holy Qur'an
Takaful	collective protection or Islamic insurance scheme
UkhuwwahIslamiah	brotherhood among Muslims
Waqaf	an Islamic endowment of property to be held in trust and used for a charitable or religious purpose
Zakah	compulsory almsgiving(generally equal to 2.5 per cent) that paid once a year on saving, gold, commodity production or monthly based on regular income (salary).

Indonesian Terminology

Abangan	Javanese Muslimswhose beliefs and practices that include Hindu, Buddhismand animist traditionsas well as Islamic elements (Geertz 1960)
Aliran	cultural stream, often linked tospiritual beliefs of traditional Javanese
Banjar	traditional village in Bali
Dakwah	religious preaching
Jemput Bola	official visits client
KeluargaPra Sejahtera	destitute family
Keluarga Sejahtera	more prosperous family
Kyai	Islamic cleric
MasyarakatMadani	prosperous society in term of religious and socioeconomic values
Pengajian	gathering where the participants recite the Holy Qur’an and discuss religious matters
Pesantren	Islamic boarding school
Priyayi	traditional Javanese bureaucratic elite whose values reflect hierarchical Hindu-Javanese traditions as well as Islam(Geertz 1960)
Santri	*Pesantren*-educated Javanese Muslimsand more devout Muslims oriented to the mosque and the Qur'an (Geertz 1960)
SuasanaAgamis	religious nuance

CHAPTER 1
RESEARCH BACKGROUND

Microfinance has been widely used as a poverty alleviation strategy in many countries. One of the objectives of microfinance is to break down the poverty cycle by providing financial services that enable poor people to earn income through various productive economic activities and to improve their welfare (Aghion and Morduch 2005; Robinson 2001; Yunus and Jolis 1998; Zeller and Meyer 2002). It is quite common for microfinance to be associated with socio-development programs such as healthcare, family planning, gender empowerment and business development services (Remenyi and Quinones 2000).

As microfinance programs have developed, there has been a growing interest in how microfinance and religious teachings relate to each other (Harper et al. 2008). Similar to other Islamic countries' practice, in Indonesia in the early 1990s, an Islamic microfinance was introduced to address chronic poverty and to broaden access to financial services in Muslim communities. This Islamic -based microfinance model is called, in Arabic terminology, *Baitul Maal Wat Tamwil* (BMT) and it has become a significant alternative microfinance program alongside its conventional counterpart.

As microfinance programs have developed, there has been a growing interest in how microfinance and religious teachings relate to each other (Harper et al. 2008). In Islamic countries, for instance in Indonesia in the early 1990s, Islamic microfinance was introduced to address chronic poverty and to broaden access to financial services in Muslim communities. One of the popular faith-based microfinance models is called, in Arabic terminology, *Baitul Maal Wat Tamwil* (BMT). It has become a significant alternative microfinance program alongside its conventional counterpart.

This study examines the role and performance of BMT institutions as an Islamic community-based microfinance system in the Special Region of Yogyakarta (DIY).[1] This introductory chapter presents the framework of the study. The main discussion is an overview on poverty alleviation and microfinance programs that briefly presents the

[1] In this study, the term 'Special Region of Yogyakarta' is used interchangeably with 'Yogyakarta'.

incidence of poverty and examines the government strategies to improve the livelihood of poor people using a microfinance approach. The following discussions outline the purpose of the study and the research questions. In addition, a section of significance of study is presented as well to identify the knowledge gap in the Islamic microfinance field, and in particular to address the critical issues of the BMT system that have not been explored by previous research. Finally, the last section outlines the thesis structure.

1.1. Overview of Poverty Alleviation

Poverty alleviation is a persistent enemy of development. Although there have been numerous endeavours to improve the livelihood of poor people, the incidence of poverty and the number of destitute people in the Special Region of Yogyakarta remains quite high. According to the Central Statistical Body (*Badan Pusat Statistik* or BPS) report, the number of people living below the poverty line as of March 2012 was 29.13 million (11.96 per cent); this figure comprises 9.23 per cent in urban areas, and 15.12 per cent in rural areas, respectively (BPS 2012).

Table 1.1. Percentage Poverty Trend Line (2008–2012)

	2008	**2009**	**2010**	**2011**	**2012***
1. Total	15.42	14.15	13.30	12.50	11.96
2. Urban Area	11.65	10.72	9.87	9.23	9.23
3. Rural Area	18.93	17.35	16.56	15.72	15.12

Source: BPS (2012).
Note: * As of March 2012

The incidence of poverty is significantly higher in rural areas where a great number of poor inhabitants live and depend upon subsistence agriculture and the informal sector (BPS 2012). The pattern of rural poverty in Indonesia has not changed much since the colonial period (Dunham 2009; Geertz 1963a; Manning 1988). This is related to limited farming income as the majority of poor households own only tiny pieces of land and destitute inhabitants are dependent upon low wages from farm-based labour. The characteristic of poverty is also related to structural constraints, for instances lack of infrastructure, inadequate economic opportunity and limited sources of capital that have pressured poor people to conduct off-farm income-generating activities, self-employment and microenterprise, as an alternative and/or additional source of income.

While in the urban area, poor people occupy predominantly the informal labour market sector with marginal and irregular income to support high living costs, especially to access clean water, energy, rental housing, basic foods, health care and education for their children. In short, the characteristics of rural and urban poverty are very similar in the Yogyakarta region where the study is conducted (see referral discussion in Chapter IV).

Drawing from the BPS database (Table 1.1.), in the last five years there has been steady progress of poverty reduction programs: the proportion of people living below the poverty line declined by nearly 4 per cent. Also it shows a consistent downward trend year by year both in urban and rural areas. Further analysis by using the dataset from the National Population and Family Planning Agency (*Badan Koordinasi Keluarga Berencana Nasional* or BKKBN) demonstrates a gradual improvement in the welfare of those in the Destitute Families category (*Keluarga Pra Sejahtera*) which shift to the Welfare Family category (*Keluarga Sejatera*) or near poor households. For instance, from 2010 – 2011, the number of Destitute Families that became classified as Welfare-I constituted approximately 364,941 family households or equivalent to 1,459,764 inhabitants; an average family normally consists of 4 persons (BKKBN 2012).

Despite the fact that poverty alleviation has been progressing, the current declining rate of poverty is likely to be less rapid than the performance before the economic crisis. According to Suryahadi et al. (2012), economic growth is an important determinant factor toward the success of the poverty alleviation program. In this respect, in the last two decades before the financial crisis of 1997–78, the annual economic growth achieved, on average, 7.5 per cent growth, which could reduce the poverty rate from 40.1 per cent in 1976 to 11.3 per cent in 1996. While after the crisis, the annual economic growth was slightly above 5 per cent, which only drove poverty from 18.2 per cent in 2002 to 11.9 per cent in 2012.

It is equally important to take into account that the current poverty figure remains high, and contains a substantial number of poor people in vulnerable situations, who are slightly above the poverty line and very sensitive to socioeconomic shock and natural disaster, (Suryadarma and Sumarto 2011). For example, in 2008 the poverty rate was 15.4 per cent, however based on the international poverty line measurement (PPS USD 2 per day), the number of poor population was nearly 42.6 per cent (Suryahadi et al.

2012). The figure is akin to the survey of BKKBN that accounted for approximately 32.6 million households –equivalent to a population of 120.4 million – who were in a vulnerable condition, mainly in the category *Keluarga Sejahtera I* and *Keluarga Sejahtera II* (BKKBN 2012). In other words, the findings suggest that poverty is very dynamic and requires further policy development to address the issues.

The government's grand strategy toward poverty alleviation has been influenced by the World Bank policy (Prihartinah 2005). In the New Order era (1967–1998), the strategy focused on a public subsidized approach in order to maintain affordable rice and energy prices, political stability, and high economic growth through the enhancing role of state-owned companies and private conglomerates; this strategy was known as the trickle-down effect. Accordingly, during and after the economic crisis,[2] the poverty alleviation policy was a top priority and the government allocated significant funds from the national budget to alleviate the impact of the crisis. In particular, the government introduced a social safety net program to support destitute households to cope with the economic shock.

Since 2004, the government administration under the presidency of Susilo Bambang Yudoyono has introduced a triple track strategy: pro-growth, pro-job, and pro-poor (Presiden Republik Indonesia 2006). Furthermore, in the second term of his presidency, in 2009 the government introduced the Presidential Decree No: 13/2009 that establishes a new strategy to address unemployment and poverty by expanding the social protection schemes in line with community empowerment and local economic development (Suryahadi et al. 2012). In brief, the antipoverty policy is summarized below:

1. Providing social security for destitute and vulnerable poor family households. The assistance is aimed to provide basic needs including subsidized rice and fuel, access to health care, school fees, including temporary cash assistance as a compensation for increasing petrol prices.
2. Introducing community empowerment programs by providing direct grant funds to less-developed villages. The program is based on grass-root initiatives and run by the community, and the fund is used to improve economic facility or to finance

[2] During the era of the presidential terms of B.J. Habibie (1998–1999), Abdul Rachman Wahid (1999–2001) and Megawati Sukarno Putri (2001–2004).

income-generating activities that are specifically related to the community members. The program is managed under the National Program People Empowerment (*Program Nasional Pemberdayaan Masyarakat Mandiri* or PNPM-MANDIRI).[3]

3. Provision of microcredit under the government guarantee scheme (*Kredit Usaha Rakyat* or KUR-Mikro). The objective of the program is to broaden financial access for un-bankable microenterprises that encounter collateral constraint and to establish a linkage of state-owned banks with community-based microfinance institutions, including BMTs.

By employing an integrated antipoverty program, the government sets a progressive target to reduce the number of poor to 8.0 per cent in 2014; on average the poverty level is decreased by 1 per cent per year. This objective seems too optimistic; for instance, Thirkell-White (2012) argues that this poverty reduction target would not be achieved because the economy faces structural constraints especially to create sufficient employment opportunities in the formal sector in urban areas. For this reason, he suggests the government needs to strengthen the informal economy, in particular the microenterprise sector that has been proven to be able to create a million jobs and income generation activities at the household level.

1.2. Role of Microenterprise in Poverty Alleviation

For many years, the microenterprise sector has played an important role in poverty alleviation. The framework of microenterprise as an antipoverty tool is based on its function and role in enabling poor people to engage in various economic activities. In other words, the microenterprise activity would allow them to generate income for living and to escape from the poverty trap. In short, by involving poor people into the microenterprise sector, it would promote sustainable economic growth rather than through short-term charity-based programs.[4]

[3] PNPM-MANDIRI was introduced in 2007. It comprises four basic programs that help poor people become self-reliant and sustain their wellbeing. The government provides a revolving fund that is managed by the poor people, and a capacity-building program to foster their independence, governance and responsibility toward the program. PNPM covers approximately 70,000 villages, and is aimed at stimulating pro-poor economic growth at the local level, while also strengthening governance and institutions (PNPM-MANDIRI 2012).

[4] The popular expression for this empowerment policy is also called ‘giving a fishing rod rather than fish’.

According to Law No: 20/2008 regarding micro, small and medium enterprises (*Usaha Mikro Kecil & Menengah* or UMKM), microenterprise is defined as a unit of business that is owned by an individual or sole-proprietorship with total maximum net asset of IDR 50 million (excluding land and property), and a maximum business turnover of IDR 300 million. It is important to note that often the definition of a microenterprise overlaps with that of a small enterprise; in this section, the discussion is focused on microenterprise.

In general, a microenterprise is associated with the informal economy (Versluysen 1999). The predominant characteristic of a microenterprise is that it is easy to enter and exit as it need less capital, simple technologies, depends upon local resources and raw materials and very flexible in term of modus operandi (Tambunan 2007). Formally, for statistical purpose, the Ministry of Cooperative and Small and Medium Enterprise (*Kementerian Koperasi dan Usaha Kecil Menengah* or MENEGKOP-UKM) organizes microenterprises into nine sectors such as agriculture, mining, manufacture, energy, property, trade and tourism, transportation and communication, finance and services.

The microenterprise sector can be classified into rural and urban bases. In rural areas, the microenterprise sector is a dominant economic player (Tambunan 2007). It is tied to agriculture and the cottage industry structure that includes craftsmanship, off-farm business, food processing, and petty trading in traditional markets (Dunham 1988; Chandler 1984). In contrast, in urban areas, microenterprises are involved with manufacturing and service sectors and include more diverse business types than in the rural areas (Vial 2011).

Table 1.2. Microenterprise Trend Line (2006–2010)

	2006	**2007**	**2008**	**2009**	**2010**	**%**
Unit	48.51	49.60	50.84	52.7	53.82	98.8
Employment	82.07	84.45	87.81	96.2	99.40	90.9
Contribution to GDP	588,5	620,8	655,7	682,2	719,0	32.4

Source: MENEGKOP-UKM (2012).

Drawing from Table 1.2, there were approximately 53.8 million microenterprise units in 2010, which constitutes 98.8 per cent of total enterprises. According to the Rural Investment Climate Survey 2009 cited in McCulloch, 2009, a vast majority (over 90 per cent) of microenterprises are household based and are run by the head of the family or another family member. Moreover, using the database from the BKKBN survey in 2010, it is apparent that nearly all microenterprise units are owned and managed by low-income families (BKKBN 2012). It is equally important to note that the microenterprises are predominantly run by Indonesian Muslim entrepreneurs (Singh et al. 2004) and many of those are women (Weijland 1999).

Following the financial crisis in Indonesia in 1998, the microenterprise sector showed significant progress. In this respect, the crisis has changed the livelihood of the majority of the population, including in Yogyakarta where the study is conducted (Widyatmoko 2008). For low-income households, microenterprises are the most possible survival strategy to cope with shortage of income and to escape from the poverty trap. For example, in urban and nearby areas the number of microenterprises grew rapidly due to massive job terminations in manufacturing and other urban economic sectors. In addition, microenterprise is a means for poor people to be engaged in a number of production activities as a favourable alternative source of income during hardship (Dunn et al. 1996). In other words, the evidence shows that microenterprise sector has played an important role in the economic recovery process.

The microenterprise sector was a major contributor to employment. Data of MENEGKOP-UKM shows, in 2010, the sector employed nearly 90.9 million people or, on average, every microenterprise employs nearly two workers, while well-established and growing microenterprises could employ up to five staff (MENEGKOP-UKM 2012). In addition, however, it is common that employment in the microenterprise sector involves other family members and some unpaid labour for example the workers may be paid in kind, e.g. food. As mentioned earlier, one of the severe impacts of the economic crisis was a decline in job opportunities in urban and surrounding industrial centres, where the majority of households were heavily dependent on wages. Microenterprises had a very critical role in absorbing a low-skilled workforce. In rural regions, microenterprise is a primary job provider of off-farm employment and seasonal excess of the agricultural labour force, i.e. during drought periods. Microenterprise can be seen as an income safeguard for landless poor households and equally worth noting that microenterprise plays a central role in slowing down the urban migration of unskilled workers.

It also reveals that, although the microenterprise sector is dominant in term of employment numbers and job creation, contribution of the sector to the gross domestic product (GDP excluding the oil and gas sector) was only 32.4 per cent in 2010 (MENEGKOP-UKM 2012). It is important to understand that microenterprises are based on lower capital and simple technology, therefore the output (goods and services) are of less value compared to that produced by medium and large enterprises. In this context, the GDP contribution should be seen from the perspective of poverty alleviation as the sector contributes to greater equity and employment rather than macroeconomic development; the latter is more influenced by medium and large enterprises (Dunham 2009). In summary, it is evident that the microenterprise role in poverty alleviation is critically important, and it also should be considered as one of leading factors to sustain economic development. It is evident that microenterprise as means of income-generating activities for poor households plays a role in wealth distribution and financial safety mechanism in the community (Tambunan 2000). In addition microenterprise activities create demand for financial services, including microcredit, micro-saving, micro-insurance and other innovative financial products.

1.3. Overview of Microfinance in Poverty Alleviation

Microfinance has been an effective tool for poverty alleviation; as the World Bank report on financial inclusion asserts, availability of continuous access to finance can break the poverty circle (World Bank 2010). In particular, microfinance enables poor households to engage in production and service economic activities, and earn sustainable income (Robinson 2002). Microfinance not only provides cash injection through different kind of microcredit schemes, but it is also a means of saving by depositing excess income for further usages and emergency (Zeller and Sharma 2002).

Microfinance had been practised in Indonesia for more than a century when the Dutch colonial administration, with support from prominent Javanese Muslim aristocrat,[5] established a microfinance institution that was adopted from the Raiffesien cooperative model. The primary mission of the microfinance institution was to counter massive

[5] The birth of the first cooperative microfinance in the town of Purwokerto in the Central Java region was supported by Raden Aria Wiriaadmadja. For his significant role, he has been recognized as a founding father of Bank Rakyat Indonesia (BRI 2012).

moneylender and usury loan practices in the Javanese communities (Henley 2009; Robinson 2002). Since then the microfinance model has evolved into several variants of institutional form, legal status and modus operandi (Charitonenko et al. 2004; Holloh 2001; Robinson 2001).

It is the government's objective to adopt microfinance in the poverty alleviation framework to support rural-agricultural development, the microenterprise and cooperative sectors. People living under the poverty line, in particular the destitute or the poorest of the poor, as discussed earlier, the government intervenes through social security assistance and community empowerment programs. The nature of the microfinance approach is a two-pronged model: subsidized and market-based mechanisms[6] and it comprises diverse financial instruments including microcredit and credit guarantee schemes. In addition, for specific target programs, there is additional technical assistance, supervision, and other policy interventions needed to ensure the program has a broad outreach among poor people and microenterprises.

The objective of subsidized microfinance is to finance un-bankable borrowers and the near-poor households that run microenterprises. The main feature of this microcredit scheme is lower interest rates. Usually the interest rate is set by the government and uses the central bank certificate interest rate as a benchmark. In many cases, the loan is specifically designed for particular government programs in the agriculture sector, family planning, cooperative development, disaster recovery projects, and other anti-poverty and community empowerment activities. In comparison, commercial microfinance is targeted to well-established microenterprises that are run by better-off poor households, but technically are regarded as un-bankable borrowers by commercial bank standards. As it adopts the market-based practice, individual microfinance institutions determine a loan interest rate without interference from the government or other financial regulators and its orientation is to gain profitability and sustainability.

Beside the above division, the microfinance system is also classified into formal, semiformal and informal sectors, which refers to the regulatory framework applying to each sector (Gallardo 2001*).* The formal microfinance sector comprises of commercial

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[6] In the literature the microfinance model is also called '*Welfarist*' for subsidized microfinance, and '*Institutionalist*' for commercial microfinance. (See the more detailed discussion in Chapter 2.)

and rural banks. The semiformal microfinance sector consists of cooperatives and other government microfinance institutions. The informal sector consists of unregulated microfinance providers, including moneylenders. A more detailed discussion of the microfinance sector will be found in Chapter 4.

In addition to the conventional microfinance models in the middle of the 1990's, Islamic microfinance has been introduced by a group of Muslim intellectuals and entrepreneurs in association with the initiation of an Islamic bank (Bank Muamalat Indonesia or BMI). The microfinance model is called Baitul Maal Wat Tamwil (BMT). The initiative is inspired by pioneer of Islamic microfinance in Egypt in the 1960s (Abdul-Rauf 2010; Antonio 2004), and a non-interest-based cooperative system that was established by Islamic student activists in 1980 and the Linkage Program Between Bank and Community Group (*Program Hubungan Bank dan Kelompok Sosial Masyarakat* or PHBK) in 1988.

Similar to its counterpart, the Islamic banking system, the BMT approach is a faith-based microfinance system, and it adopts a profit-sharing financial intermediary system. Azis (2004) points out that the origin of the BMT system is developed from an idealistic concept of an Islamic economy and religious teachings about poverty. Thus the BMT system employs a unique modus operandi by combining profit-oriented microfinance (*Baitul Tamwil*) and a philanthropic (*Baitul Maal*) mission. In addition, although it possesses distinctive Islamic microfinance characteristics, the BMT platform is a typically cooperative system and it is regulated under the Cooperative Law No. 25/1992.

By design, the BMT system is not affiliated with the government microfinance agenda; it is linked to Islamic organisations, mosques, and Muslim communities. In the absence of government support, the BMT developed slowly until Indonesia was hit by the economic crisis of 1997–98. Since then the government has recognized the system and its approach was adopted to strengthen the post-crisis recovery and the poverty alleviation programs. Recently, the BMT sector has become one of the important players in the microfinance landscape. Its presence has been well recognized by the majority of Muslim societies and its distinctive financial methodology is also well accepted by Muslim clients. In short, the BMT demonstrates a promising development as an alternative microfinance institution for poor Muslim households.

To understand the dynamic phenomenon of the BMT approach, this study explores the development of the BMT system since its initiation and examines its role as an Islamic community-based microfinance system in the Special Region of Yogyakarta. This research is a case study in nature and Yogyakarta is selected because it is critically important to the BMT movement and the development of faith-based microfinance.

1.4. Research Objectives

The main objective of this study is to analyse the development of the BMT sector in Yogyakarta and in particular to examine its presence in the Javanese Muslim community. The specific objective of the study is to address two main issues. First, to analyse the BMT system from several perspectives including (a) historical development, (b) institutional structure and attributes, (c) regulation and supervision, (d) modus operandi and (e) equally to examine the BMT model in the context of Indonesian microfinance and Islamic banking. Second, to examine (a) the BMT performance and sustainability, and (b) its dual objectives – profit and social missions.

1.5. Research Questions

The main research question is to determine the extent of the role of the BMT institutions as the Islamic microfinance model in the Javanese Muslim community, and to what extent the BMT institution is sustainable.

In particular the study examines 4 sub-research questions that influence the role and performance the BMTs:

1. How has the BMT system developed and what were motivations behind their establishment? To what extent have the objectives been maintained? How do the BMTs embrace the religious values of Islam? How do the BMTs interact with the local economic and the Muslim Javanese socio-cultural environment?

2. What is the BMT's operational platform? What are the distinctive features and what are its strength and weaknesses? What is its modus operandi, products and services? To what extent are the practices of the BMTs consistent with *Sharia* principles?

3. To what extent have the BMTs been involved in poverty alleviation? To what extent do the BMTs perform dual functions as profit-oriented microfinance and religious philanthropic organisations?

4. To what extent are the BMT's activities operationally and financially sustainable? What factors influence the sustainability of the institution? Are there advantages in being a faith-based microfinance organisation? To what extent does being faith-based make the BMT institution more sustainable? Are BMTs more sustainable than conventional forms of microfinance?

1.6. Significance of the Study

There is a great variety of research on microfinance available in academic literature. In many instances, the research topics discuss different schools of thought and models of microfinance, and their sustainability (Morduch 2000; Robinson 2001; Woller et al. 1999; Yunus and Jolis 1998; Zeller and Meyer 2002). In addition, other studies address quite specific topics regarding the role and performance of the microfinance institutions, for examples the Grameen Bank in Bangladesh (Dowla and Barua 2006; Khandker et al. 1995), Bank Rakyat Indonesia (Patten et al. 2001; Robinson 2002), and self-help groups in India (Sinha et al. 2009). Equally, research on microfinance in Indonesia has been extensive, for instances, the performance of government microfinance programs (Kaluge 2001; Prihartinah 2005), commercial microfinance (Robinson 2002), rural credit institutions (Arsyad 2006), and rural banks (Holloh 2001; Sunarto 2007).

Lately, since Islamic banking has grown rapidly in Islamic countries, faith-based banking systems have attracted the attention of many scholars, however, according to Astha and Selva (2011), the study of Islamic microfinance is still limited. During this research, there are only a few studies of Islamic microfinance that comprehensively discuss and examine the system (Al-Harran 1993; Dusuki 2005; Haque and Yamao 2011; Harper et al. 2008; IRTI 2008; Khan 2008; Obaidullah 2008).

Increasingly, Indonesian Islamic microfinance has been studied and widely discussed by researchers and in particular there are a number of studies about the BMT system. Adnan et al. (2003) conducted a study to measure the performance of 47 BMT institutions in five regions in the Java island. The study employs a quantitative methodology to examine the relationship of different variables of BMT management, types of products, characteristics of the customers, perceptions of customers and the BMT approach to maintain the customer base and the sustainability of BMTs. This research found that the BMT management and product attributes strongly influenced the financial performance of the BMTs.

Antonio (2004) discussed the discourse and polemic of *Riba* along with the initial development of Islamic banking in Indonesia. In addition, the study examines the advancement of small and micro financing in providing financial services to Muslim entrepreneurs around Jakarta. The finding suggests that Islamic microfinance could play a significant role in strengthening micro and small enterprises. Compared with the conventional approach, to some extent, Islamic microfinance is more suitable for un-bankable borrowers. Islamic microfinance, with its uniqueness, could perform its mission to alleviate poverty and be sustainable as well.

Nurhayati and Wahyuni (2007) analysed the financial performance of two BMT institutions in Jakarta. The study uses a composite rating developed by the Center of Small Business Incubation (*Pusat Inkubasi Usaha Kecil* or PINBUK), which comprises five financial indicators: capital structure, quality of productive asset, efficiency, liquidity, and sustainability and continuity. The study found that both BMTs' performance was sound and operationally sustainable.

Cokro and Ismail (2008) examined the sustainability of 60 BMT institutions across Indonesia over the period of 2002 to 2005. The study uses two approaches to assess BMTs' sustainability: technical efficiency (using Data Envelopment Analysis) and the level of outreach. The study found that the efficiency of BMTs was relatively low but were able to sustain profitability. In addition, the presence of BMTs contributed social benefits to Muslim society. In general, the BMTs achieved sustainability and were able to provide viable Islamic microfinance.

Sakai (2008) explored the role of BMT institutions and their contribution to community development. In another study Sakai (2010) examined the role of BMTs in Central Java in relation to women's position in traditional markets. From the case of BMT Beringharjo's Bisa scheme, Sakai found that BMT could fulfil the needs of most women micro entrepreneurs who were excluded from the formal banking system.

Amalia (2009) examined the role of 48 BMTs in fostering microenterprise in five regions and analysed the BMT model as to whether it could be used to promote a more equitable distribution of wealth under the Islamic economic concept. The study employs qualitative methodology to assess the BMT's performance and its impact to clients, and government policy that supports the microenterprise sector. Amalia showed that the BMTs are widely accepted and their product generates benefits to the clients, particularly loans for financing business.

Aryo (2009) assessed the adoption and implementation of neo-liberal thinking in microfinance programs as a poverty alleviation strategy through partnership between the state and NGOs (BMT-Kube program). The study found that the program could assist poor individuals to become micro-entrepreneurs, and build positive spirituality and mentality. In addition, the government intervention is critically important to protect the poor households toward unwanted impact of market-based economy policy.

Hadisumarto and Ismail (2010) carried out a study to examine the effectiveness of BMTs' contribution to microenterprises' performance in Central Java. The study uses a simple statistic test (T-test) to measure the impact of the BMT loan to micro business clients. The finding suggests that the BMTs successfully provide financial service to microenterprises and improve the clients' income as well. The study also identifies internal procedures of the BMTs including the borrower selection process, loan monitoring and control, and the incentive system. It showed that good relationships between BMTs' personnel and clients influence the effectiveness of the BMTs' overall financing performance.

Pepinsky (2012) conducted a study to investigate the motivation, perception and underlying reasons of individual Muslims in Indonesia in using Islamic finance products and being customers of Islamic banks. The study employs a large database from a national survey of 2548 Indonesians (2241 Muslims, or 88% of the total sample) from a majority of provinces. The survey focused on personal views on contemporary economic and political conditions in Indonesia including the respondents' opinion and perception of Islamic finance products. The study found that religious issues are not a main impetus of respondents in using the services of Islamic banks and using sharia compliant transactions. The study concludes that Islamic contemporary issues such as rising middle-class phenomenon, modernization and globalization have strongly influenced Muslim preferences toward the Islamic finance and banking products.

In spite of these studies about the BMT system, there are gaps in our knowledge that will be examined and explored in this study. Firstly, this study provides a comprehensive analysis in order to explore the emerging phenomenon of BMT institutions in Yogyakarta. The study investigates the BMT institutions presence in Javanese Muslim society and in the economic setting where microenterprise and the agriculture sector are interlinked. Secondly, the study examines the interaction of the BMT institutions within the local Muslim communities. This analysis enriches our knowledge and understanding of how Islamic organisations and local Muslim figures become involved in and influence the development of the BMT institutions.

Thirdly, this study fills the gap in the academic literature concerning how the BMTs operate in the environment that has been dominated by conventional microfinance and in a society that is more familiar with interest-based financial transactions. Lastly, the research findings and the recommendations that will flow from the findings provide guidance to the government, Islamic organisations and others in order to strengthen the BMT system. Also, the study could be a reference for other Islamic countries that are interested in adopting the BMT model.

1.7. Career and Research in Microfinance

I became interested in microfinance when I started my banking career at Bank Rakyat Indonesia (Bank BRI) in 1989. My work in the Research and Development Division enabled me to intermingle with consultants from Harvard International Institute of Development and USAID, including Ann Dunham, the mother of President Obama, who conducted research about the Kupedes microcredit program. As part of my Master of Agribusiness degree at the University of Melbourne in 2000–01 I wrote a final assignment on the impact of the Kupedes program during the Financial Crisis of 1997–98. In 2002, I was appointed as senior microfinance specialist or microbanker, the term I prefer. From 2002 to 2007, I developed an international network with other microfinance specialists and spoke at a number of international seminars and conferences including being involved in the working group of the United Nations Adviser on Financial Inclusion. In addition, during my assignment as head of BRI branch office in Central Java, I gained much practical experience about how to develop microfinance services in the different socio-culture background of the communities of Central Java.

During the Indonesia Microfinance Year 2006, as secretary of the National Committee of Microfinance (*Komite Nasional Pemberdayaan Keuangan Mikro Indonesia* or PKMI), I was involved in drafting the Microfinance Law and other initiatives to strengthen the microfinance sector. Through the PKMI network, I learnt more about the BMT system and met with architects and prominent supporters of the BMT system, including Professor Amin Aziz (Founder of PINBUK and ICMI member), Erie Sudewo (Founder of Dompet Dhufaa Foundation), Aris Muftie (Chairman of ABSINDO) and other BMT activists, i.e. Saat Suharto (Director of the Permodalan BMT).

Through this network I was invited to speak at the BMT Center Annual Forum in Jakarta and I became an advisor to the Permodalan BMT (PBMT). Together with Rudjito, former Chief Executive of Bank BRI, I established the Microbanker Connection to support Islamic microfinance in Indonesia as the majority of BMTs lack capable human resources and capital to grow, and as well as I actively in publishing articles on microfinance and BMT in newspapers and blog.

To develop my knowledge of the BMT sector further, I chose the BMT sector established around Yogyakarta as the topic of my PhD program at Victoria University. With my professional background as a micro-banker, I bring an ‘insider‘ perspective to this study. My practical experience and knowledge of microfinance has influenced the conduct of the research and provided access to many of the leading figures in microfinance and especially Islamic microfinance.

1.8. Thesis Outline

This thesis is organized into 10 chapters. Chapter 1 introduces the background of the study, the objective and research questions, the significance of the study, the contribution to the knowledge, and my career and research in microfinance.

Chapter 2 discusses the Islamic approach toward poverty and the implementation of Islamic microfinance concepts in alleviating poverty. Accordingly, the discussion reviews the several microfinance schools of thought and the ongoing discourses including a comparative analysis between the conventional and the faith-based approaches to microfinance. The chapter also reviews the development of Islamic microfinance and several challenges that face the sector. In addition, the discussion is expanded to address sustainability issues that are critically important to the long-term operation of Islamic microfinance.

Chapter 3 discusses the research approach and methodology used in this study. The general framework of the research is a case study of the BMT sector in Yogyakarta. The sample of BMT institutions are purposely drawn from the Apex BMT membership and continuously monitored over a three-year period (2008–2011). Furthermore, in order to enrich the analysis, a triangulation approach has been developed to capture the qualitative and quantitative characteristics of the BMTs. The triangulation technique is a mixture of the qualitative findings collected through in-depth and semi-structure interviews, focus group discussions, questionnaires, and the quantitative financial dataset (balance sheet, and profit and loss). In addition, secondary data has been collected to examine the socioeconomic background in the Yogyakarta area, to overview the microfinance landscape and Islamic banking and finance sector at the national level. Finally, the research process follows the academic practice including establishing research ethics, data collection technique, data validation, data processing and integration.

Chapter 4 describes the socioeconomic setting of Yogyakarta. There are three issues that are related to the BMT sector: first, to understand the uniqueness of Yogyakarta as a special province in the era of autonomy and the role of the Sri Sultan Hamengkubuwono X as a governor and also a descendent of the Mataram ruling family. Second, to analyse the Javanese socio-culture, customs and traditions that are influenced by syncretism, Hinduism and Islam. Lastly, the character of the local economy is examined, including the nature of poverty and the livelihood of the population, the structure of the informal economy, the microenterprise and microfinance sectors, the pattern of economic growth, and the critical sector for the region’s development.

Chapter 5 provides an overview of the microfinance sector in Indonesia. The chapter introduces the microfinance sector and the variety of microfinance providers, both conventional and Islamic-based approaches. A review of the historical development of microfinance, and the involvement of the government in influencing the microfinance sector are also presented. The subsequent discussion reviews the development of microbanking and the growing involvement of commercial banks in microfinance, as well as the position of the rural bank in the banking landscape. Equally, the role and performance of cooperative microfinance and several leading non-bank and community-based microfinance institutions are discussed, in association with the government microcredit guaranteed program and the newly-established revolving fund institution to support the cooperative microfinance including the BMT sector.

Chapter 6 is an overview of the Islamic banking sector in Indonesia. The nature of the discussion is to portray the latest position and roles of the faith-based financial model under the dual banking and financial system. The introductory section addresses the endeavour of Muslim elites to initiate the Islamic banking and Islamic microfinance system under the repressive government regime. The following section discusses in detail the performance of the Islamic commercial banking and the Islamic microbanking sector. Furthermore, to provide a thorough picture of the industry, brief descriptions pertaining to the Islamic pawnshop and charitable funds mobilization are presented as well. Finally, the chapter addresses the future challenge and prospects for the Islamic banking industry.

Chapter 7 discusses the background and motivation behind the creation of the BMT system and its historical development since its inception. The BMT sector and its position in the Islamic banking and finance landscape are presented, as well as a description of the relations between the BMT sector and the other Islamic financial institutions, including the linkage with several leading Islamic organisations.

Chapter 8 analyses the role of BMTs in Yogyakarta. In this chapter, the central discussion addresses the main research questions, in particular seeking to understand why and how the BMT system develop in Javanese Muslim society and to identify the factors that influence the faith-based microfinance system in the local economic environment that have been dominated by conventional microfinance institutions for many decades. The chapter is structured into three main discussions. First, an exploration of the BMTs' development pattern, and the actors, supporters and the motivation behind the BMT movement. Second, an identification is made of the attributes of the BMT system. Finally, the discussion exhibits the nature of the *Baitul Maal* modus operandi in performing its socio-religious mission.

Chapter 9 examines the performance of the selected BMTs in the period of 2008 to 2010. The framework of analysis and discussion addresses the main research questions: to measure the sustainability of the BMT institution; to examine how the Islamic community-based microfinance system sustains its operation and to what extent does being faith-based make BMTs more sustainable; and what factors influence the sustainability of the sector.

Chapter 10 is the conclusion and makes recommendations relevant to government policy and stakeholders in the BMT sector. The study identifies the significant findings in relation to the research questions and the study objectives. This chapter summarizes the findings and the theoretical implications of the study.

CHAPER 2

THE ISLAMIC MICROFINANCE APPROACH TOWARD POVERTY

Poverty alleviation and microfinance are interrelated issues since microfinance is viewed as one of the means to alleviate chronic poverty through the provision of financial services that enable poor people to engage in economic activities and, in turn, to generate income for their families. In this chapter, the discussion addresses poverty alleviation and microfinance, in particular to demonstrate that Islamic microfinance is a new approach to alleviating poverty in Muslim communities.

The first section discusses the Islamic tenets in addressing poverty as written in the Holy Quran and the teachings of the Prophet Muhammad. This section also reveals the nature of the Islamic teachings on alleviating poverty and how to empower poor people to become self-reliant in sustaining their livelihood.

The second section discusses various schools of thought and the roles of microfinance in poverty alleviation, in particular opening financial access for the destitute, poor and micro entrepreneurs. It will examine theories and debates that argue that access to financial systems would allow disadvantaged households to improve their livelihood in many ways. The purpose of the discussion in this section is to assess the debate of whether microfinance should be subsidized or should be a market-based system to sustain the program.

The third section discusses the main concept and technical terms of the Islamic microfinance system and identifies its differentiation from the conventional counterpart. It includes a discussion of the prohibition of interest payments in Islamic microfinance models and its financial instruments, and the latest developments in the Islamic microfinance sector and other relevant issues. Finally, the discussion focuses on the sustainability of microfinance programs and what factors drive microfinance institutions to be financially sound and sustainable.

2.1. Islamic Teachings on Poverty

Poverty has been a topic of discussion for many decades. One of the challenging issues is how to construct an inclusive concept and definition of poverty that is relevant to different contexts and dynamic changes in economic, socio-cultural and political conditions from rural to urban areas, from one region to another and from one country to another.

There has been much debate about the definitions of poverty (Spicker et al. 2007). A general definition of poverty is a state of being poor; poor is having very little money with which to buy one's basic needs. The World Bank defines poverty as a deprivation in wellbeing related to income[7] (Haughton and Khandker 2009). There are many studies that argue poverty has a meaning beyond economic and monetary issues (Hagenaars and Vos 1988). In fact, poverty is far more complex and has multiple dimensions (Sirageldin 2002) hence, concepts of poverty have been significantly broadened by embracing social and psychological dimensions as well.

Nobel Laureate, Amartya Sen is a proponent of a concept of absolute poverty (Beard 1999), which argues that poverty is lack of freedom caused by inadequate income, no education, poor health, insecurity, hopelessness and a lack of self-confidence (Haughton and Khandker 2009). A more inclusive poverty concept has been introduced in the World Summit for Social Development 1995. In the Programme of Action of the World Summit for Social Development poverty is described as a condition which is related to 'lack of income and productive resources sufficient to ensure sustainable livelihoods, hunger and malnutrition, ill health, limited or lack of access to education and other basic services, increased morbidity and mortality from illness, homelessness and inadequate housing, unsafe environments, and social discrimination and exclusion, lack of participation in decision making and in civil, social and cultural life' (the United Nations 2009, p. 8).

[7] Associated with this definition, the United Nations uses variable income in setting the Millennium Development Goals (MDGs) to halve, between 1990 and 2015, the proportion of people whose income is less than $1 per day. Moreover, to achieve this MDGs' objective, the United Nations declared 2005 to be the International Year of Microcredit, which recognized microfinance as a prominent solution to tackle poverty around the globe.

Based on this definition, the United Nations Development Programme (UNDP) developed the Human Poverty Index which takes account of multi-dimensional indicators including economic, knowledge, health and social variables as the main proxies of poverty (Sirageldin 2002). In general, the comprehensive definition of poverty is seen from biological and physical perspectives, which include basic needs and economic circumstances (Beard 1999; Spicker 2007).

Officially Indonesia uses the absolute poverty concept (Beard 1999; BPS 2012) in which poverty is defined in terms of a basic need approach (a daily food intake of 2100 kilocalories, and non-food requirements). The poverty line is measured based on a minimum amount of food and non-food spending per capita, thus a person is categorized destitute if her/his monthly expenditure is under the poverty line. For example, the poverty line per capita per month in March 2012 was IDR. 248,707, therefore a person who earns income less than that is classified as destitute (BPS 2012, p. 4). In order to comprehend the BPS concept, the National Population and Family Planning Board (BKKBN) also develops a concept that is similar to the broadened notion of poverty developed by the UNDP, among others (Prihartinah 2005).

In general, BKKBN classifies poverty into five strata:

- Pre-welfare or a destitute family (*Keluarga Pra Sejahtera*) that literally is unable to meet minimal basic needs such as food, clothing, housing and spiritual needs.
- *Welfare-I* (KS-I) has already fulfilled basic needs (food, clothing and shelter), but struggles to meet non-basic needs like education, health care, transportation and social livelihood.
- *Welfare-II* (KS-II) is a family that has already provided nearly all primary needs, except for financial security (i.e. saving) and access to information.
- *Welfare-III* (KS-III) satisfies its wellbeing in term of material, social and spiritual needs, but has limited engagement in the community and economy.
- *Welfare-III plus* (KS-III plus) that refers to a prosperous family.

In addition to the definitions, from the religious perspective, poverty has been a subject of major religious teachings (Harper et al. 2008; Lev 2005). In particular, Islamic teachings identifies poverty and the importance of poverty alleviation in many verses

(*Surah*) of the Holy Quran. Also, poverty is frequently mentioned in the teachings (*Hadits*) of Prophet Muhammad[8] (Guner 2005).

In Islamic teachings, poverty is related to the concept of basic needs (Sabra 2000; Meisami et al. 2011). In general, poverty means lack of the basic necessities or below the standard of normal life in terms of religious devotion and social life. In this respect, Islam classifies poverty into spiritual poverty and material poverty. The first category is related to deficiency of a human being in performing the Five Pillars of Islam[9] or fulfilling the basic obligations as a pious Muslim. The latter is associated with inadequate socioeconomic circumstances that are similar to the definitions of poverty (Guner 2005).

Spicker et al. (2007) contend that Islamic teachings recognizes two states of poverty: destitute (*Faqir*) and poor (*Miskin*). Naturally, both destitute and poor are people who need the assistance of others to live normal lives. The characteristics of the destitute and needy are similar to the poorest of the poor who face severe socioeconomic conditions and live below the poverty line due to physical handicap, lack of skills or absence of family support. Whilst the labouring poor live in slightly better circumstances, they still experience shortages of basic necessities because of limited access to employment, land and other material assets (Remenyi and Quinones 2000). In addition to the above categories, the Holy Quran identifies another form of poverty that is related to temporary circumstances caused by debt, illness or natural disaster (Spicker et al. 2007).

In Islam it is believed that poverty is involuntary since it is not inherited, nor a curse or punishment. Poverty is a socioeconomic and spiritual problem that endangers the individual, family and the entire society (Sabra 2000). In this context, poverty has serious implications for individuals, families and the community. First, it endangers the foundation of spiritual belief (*Aqidah*); as the Prophet points out, poverty drives people not to believe in God. Second, it erodes moral and logical thinking because poverty potentially leads people to frustration, crime and other unlawful conduct. Third, it

[8] The main sources of Islamic teachings are the Holy Quran and the *Hadist* that guide Muslims in performing religious duties and maintaining daily life. *Hadits* records the actions, role models and words of the Prophet Muhammad that should be followed by Muslims; this also refers to *Sunnah*. Discussion about poverty and the poor can be founded in some chapters of *Hadist* (Gunner 2005).

[9] The five pillars of Islam comprises: (1) submission to the only God (*Shahada*), (2) perform five times prayers (*Salah*); (3) almsgiving (*Zakah*); (4) Ramadan fasting (*Saum*); and (5) pilgrimage to Mecca (*Haj*).

creates family disharmony since lack of the basic necessities leads to child malnutrition, chronic illness, poor education and lack of quality time among family members. Fourth, wider dimensions of poverty can create conflict in the community, especially where there is socioeconomic inequality (al Qardhawi 1980).

In Islamic literature, for example, *Ahadith Al-Bukhari* asserts that many teachings of the Prophet show His concern about poverty in early Muslim society (Khan 1996). Furthermore, Guner (2005) cites the Prophet asking His companions and followers to protect their families from poverty and famine. In this respect, the Prophet clearly demonstrates that every Muslim who deals with destitution and hardship should strive to break out of the cycle of poverty. However, it important to note that poverty is also considered as an integral journey of spiritual enrichment that drives Muslims to reach the highest spiritual status. For some pious Muslims, living in destitution and conditions of hardship should not really be a problem (Sabra 2000). Equally, the Prophet also emphasizes that poverty alleviation is one of the most important aspects of the Islam doctrines. He states that Muslims have a moral duty to eliminate poverty by giving alms and charity to assist the destitute and needy.

2.1.1. Islamic Poverty Alleviation Means

The primary mechanism in Islam for alleviating poverty is through compulsory almsgiving (*Zakah*) and voluntary charities (*Sadakah*, *Infaq* and *Waqaf*) that are stipulated in the Quran and the teachings of the Prophet. In the broader context of Islamic teachings, almsgiving is the third of the Five Pillars of the religion. In the classical literature of Islam, as reviewed by Lev (2005) and Senturk (2007), almsgiving (*Zakah* in Arabic) means ‘to purify’. In the Islamic religious practice it is an obligation for every eligible Muslim (*Muzakki*) to donate a certain share of her/his wealth to support poor people and other beneficiaries for the sake of God. Furthermore, Qardhawi (1980) explains two kinds of almsgiving: the first is *Zakah al-Fitr* that is subject to an individual; it has to be performed during the holy month of Ramadan. The second is *Zakah Maal* which is related to wealth; in this discussion, almsgiving refers to the latter category. The major Islamic schools of thought emphasise that almsgiving is more than charity as it acknowledges the rights of the needy and the poor. Also almsgiving is a means of redistribution of wealth, a driver of economic growth, social justice and empowerment, and a symbol of strong brotherhood among Muslims, regardless of wealth and social status (Iqbal 2002; Kahf 2002; Latief 2012).

According to Senturk (2007), almsgiving is a levy on surplus wealth and assets, including cash income, savings, gold, jewellery, agricultural production, livestock, explored mining and hidden treasures. The common almsgiving rate for cash and its equivalents is about 2.5 per cent per annum. Agricultural commodities, livestock and mining products (precious metals and minerals) are charged 5 to 10 per cent, and lost treasure is taxed at 20 per cent. However, household items, durable assets and other non-income-generating assets are not included.

The traditional practice of almsgiving is given annually when the wealth generated exceed the threshold monetary value (*Nisab*) which is equal to 95 grams of gold at a market price (Senturk 2007). However, since almsgiving involves a growing number of Muslims working in the formal sector of the economy, routine deductions of almsgiving have been introduced (Latief 2012), which enable employees to deduct 2.5 per cent of their monthly salary rather than pay an annual sum. Apparently this new approach enables the almsgiving funds to maintain a more sustainable cash flow through the year.

Technically speaking, the Quran states that the almsgiving should be given to eight specific categories of beneficiaries (*Mustahiq*):

1. Destitute (*Faqir*),
2. Poor (*Miskin*),
3. Converted Muslim (*Mualaf al qulub*),
4. Freeing Slave (*Riqab*),
5. Person who faces massive debt (*Gharimin*),
6. Traveller (*Ibnu Sabil*),
7. Person who preaches and/or teaches Islam (*Fisabilillah*) and
8. Almsgiving collector (*Amil*).

However, in many cases, Islamic scholars differ in their interpretations of the categories of almsgiving (Senturk 2007). The traditional view refers to the literal meaning of the Quran verses, while the modernist interpretation deliberately expands the meaning of the verses in line with the context and situation which has evolved. There are various interpretations and practices of almsgiving and socio-religious charity because each Islamic school of thought uses different methods and contexts. The most common differences are related to defining particular beneficiaries, for example, interpreting the meaning of slavery and *Fisabilillah* in the context of modern world. Similarly, the mainstream Islam has different opinions about the distribution of the alms to the right recipients, but in principle, the alms are prioritized for emergency and relief assistance. Also, there is a discourse about the interpretation of the almsgiving management system. One view suggests the almsgiving should be controlled by the government in the national budget. In contrast, others favour management by independent Islamic organisations.

Equally, Islamic teachings recognises voluntary charitable giving and this tradition is widely practised in the Muslim community (Lev 2005). The nature of this charity is akin to philanthropic activity in the modern Western community (Frances and Cuskelly 2008). Typical of non-compulsory donations are those to charities (*Sadakah* and *Infaq*) and trust funds (*Waqaf*). *Sadakah* is related to an unspecific donation that is usually given to destitute and poor people on a frequent or infrequent schedule and in varying amounts. The most common form of this donation is money, food and other basic necessities. *Infaq* to some extent is perceived of as a donation to support religious programs, i.e. the operational fund for mosques (Latief 2012), while *Waqaf* is likely to be an endowment asset and/or fund that is managed by a community or religious institution for broad socio-religious objectives (Prihatna 2006). Unlike obligatory almsgiving, there is no particular rule and methodology in regulating the voluntary charities, but normally the funds or assets are interwoven with the almsgiving (Sabra 2000).

In brief, there is a general understanding that almsgiving and other philanthropic activities are the core foundations of poverty alleviation in Islamic religious doctrine (Senturk 2007).

2.1.2. An Islamic Approach to Poverty Alleviation

Economists argue that poverty is an outcome of market failure. Johnson (2009) points out that the economic system allows resources and wealth to be accumulated by particular persons and/or parties and ultimately leads to the domination of some people over others. In this situation of asymmetric power relations, people who lack capability cannot access resources and accordingly they are excluded from the economic mainstream as well as in social respects.

It has been commonly accepted that poverty is a complex and multidimensional problem (Sirageldin 2002). Therefore, to deal with the complexity of poverty, there have been numerous approaches and policies introduced, in particular the donor programs led by the World Bank (World Bank 2013) and other regional donor institutions, i.e. the Asian Development Bank in the Asian region (ADB 2007). In association with the global poverty alleviation program, in 2006, the Islamic Development Bank (IDB) introduces poverty alleviation program using south-south approach with specific Islamic characteristics (IDB 2012).

According to Sabra (2000), the essential element of poverty alleviation in Islam is focused on assisting people who are unable to be self-sufficient, through the provision of the basic necessities. The support is mainly aimed to help the destitute and the needy who have insufficient income to fulfil minimum needs in their daily lives, for instance, food, clothing and shelter, but also including non-physical needs (Debasa 2009). The Prophet introduced this approach through the establishment of the House of Treasure (*Baitul Maal*), which was designed to collect and manage almsgiving and charitable funds, and to distribute this to the poorest and other rightfully beneficiaries. After the era of the Prophet, accordingly, His successor companions enhanced the system that was expanded during in the medieval period (Lev 2005).

In the modern context as the concept of basic needs and community welfare have broadened, Islamic thinking on the poverty alleviation concept such as *Baitul Maal* and almsgiving has been developed, to include the provision of health services (Udiutomo et al. 2009), education (Helmanita 2006) and humanitarian and relief provision (Latief 2012). In other words, the Islamic poverty alleviation framework is a social security mechanism to support the poorest and the most needy (Gusfahmi 2009).

Another fundamental approach of the Islamic teachings in alleviating poverty is empowerment by providing the means and pathways that encourage poor people to become involved in income-generating activities (Dogarawa 2006). In this context, a Muslim is strongly encouraged to be a self-reliant and successful person (Abdul-Rauf

2010); this doctrine is revealed in several verses of the Quran. According to Qardhawi (1980), work for wages is the main strategy, and entrepreneurship is another pathway (Hamid and Sa'ari 2011; Ibrahim 2012; Sultan 2012). In other words, Islamic teachings has a holistic approach that highlights equality, generosity, justice and empowerment as the core values.

The historical literature of Islam describes how The Prophet, before His prophetic duty, was orphaned at a young age. He worked hard for a living, including as an assistant to a wealthy merchant to sell goods and commodities from city to city across the Arab world. Through hard work, honesty and smart trading strategies, the venture grew and finally He became a successful entrepreneur (Rahman 2010).[10] This lesson clearly demonstrates that social status should not prevent Muslims from becoming prosperous, affluent and respected in society as long as there is strong willpower to make a living. Given this history, it can be understood why The Prophet prohibits an ordinary Muslim from begging for charity and earn from the generosity of others (Dogarawa 2006).

In a different context, the prophetic tradition is to encourage Muslims to be entrepreneurs. A narrative literature, as summarized by Ibrahim (2012, p. 83) explains 'a poor man came to the Prophet asking for financial help. The Prophet recommended the man to sell any assets he has (a piece of cloth and a utensil) valued at two dirhams. The Prophet suggested the man to buy an axe and cut firewood for money. He asked the man to come back again in two weeks. When he returned to The Prophet, he brought ten dirhams generated from his effort'. Sultan (2012) points out that The Prophet's teachings demonstrates a different approach in dealing with poverty. In this case, the solution suggests that poverty can be alleviated by helping poor people to earn a living in self-employment or as an entrepreneur rather than asking for financial help from others.

Clearly the examples of the Islamic poverty alleviation approach suggests that productive activity is the most effective means to support poor people to be self-reliant and confident in dealing with economic hardship. Empowerment is a proven tool to enable the poor to help lift themselves out of the cycle of poverty.

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[10] The young Muhammad worked as an employee of Siti Khadijah's venture by delivering tradable commodities from Mecca to Syria. He was not only trustworthy but a bright entrepreneur, hence He successfully expanded the business. Finally Muhammad married Siti Khadijah (Rahman 2010).

Another important element of the Islamic poverty eradication doctrine is prohibition of *Riba* (Kaleem and Ahmed 2010). Literally, *Riba* in Arabic means 'an increase'. However its interpretation usually is related to usury, the payment of interest, and other financial and commerce transactions (Saeed 1999). The fundamental issue in *Riba* is about moral ethics and justice (Tripp 2006). In this regard, one party takes advantage of another, for example, where the wealthy exploit the poor for profit and/or benefit. Saeed (1999) notes that *Riba* has been banned since the early period of Islam because it caused chronic poverty. In the pre-Islamic period, *Riba* was widespread and the rich practised usury by charging poor people very high interest rates on loans or goods even though the poor borrowed money to make a living. In effect, this situation created widespread inequality and poverty in Mecca society.

Rahman (2010) states that Islam eliminates *Riba* through introducing benevolent loans (*Qard al Hasanah*). This model encourages affluent Muslims to lend money to poor people without seeking interest or profit, instead only asking reward from God. Also, the poor borrower would not be obliged to pay back the loan whenever he/she experiences financial difficulty. Thus the nature of the benevolent loan will not create a burden to the poor hence it is ideal as a poverty alleviation tool (Bhuiyan et al. 2012). In brief, the comprehensive poverty alleviation principle in the Islamic belief system seems very relevant in the current context especially in Muslim countries, including Indonesia, where poverty and inequality remain evident**.**

2.1.3. Institutionalized Almsgiving for Poverty Alleviation

As previously discussed, almsgiving is a teachings that was introduced by The Prophet in the early Islamic era. During the Prophetic era, there was a House of Treasure with a primary function to collect and administer almsgiving (Iqbal 2002). In the medieval period the practice of almsgiving was carried out by The Prophet's companions and Islamic nations (Debasa 2009; Latief 2012; Sabra 2000). In particular, the organisation of almsgiving was developed into a sophisticated institution (Kasam 2008; Qardhawi1980), and was integrated into the Islamic state fiscal system (taxation) and welfare program (Latief 2012).

However, with the imposition of colonial rule in much of the Islamic world, institutional almsgiving managed by the state declined (Chapra 2006). Under colonial rule, almsgiving became a socio-religious tradition, embedded in mosques and other small religious organisations. Institutionalized almsgiving was re-established in some Muslim countries with the revival of Islam following the Iran Revolution in 1979. Recently, two almsgiving and philanthropic models have emerged in Islamic nations. First, the almsgiving is institutionalized into governmental structures and the national budget system, as well as a poverty alleviation framework, as in Malaysia (Kasam 2008). Second, the state involvement is only in a regulatory or supervisory role, which allows the Islamic civil societies to develop almsgiving and poverty alleviation, as in Egypt and Jordan (Harrigan and El-Saeed 2009) and Indonesia (Helmanita 2006; Latief 2012).

In the case of Indonesia, the government role is providing legal and support arrangements; officially almsgiving activity is regulated under Law No. 38/1999 regarding *Zakah* collection and management.[11] The law provides general rules for almsgiving and also recognizes two almsgiving organisations: the government-sponsored institution (*Badan Amil Zakah Nasional* or BAZNAS) and the Islamic civil society-based agency (*Lembaga Amil Zakah* or LAZ). So the almsgiving and charitable system has been transformed into modern organisations and embraced good governance including a greater variety of poverty alleviation programs.

In line with re-institutionalized almsgiving, in many Muslim nations there is a new paradigm of integrating the traditional almsgiving framework in poverty alleviation into the Islamic economic system (Latief 2012), so that the almsgiving and religious fundraising activities are enhanced to generate significant impact for the poor beneficiaries and the wider society, and more importantly it should be sustainable in the long term. There is a growing movement that the practice of almsgiving has been associated with Islamic banking and microfinance institutions (Al-Harran 1993; Kaleem and Ahmed 2010; Kamil 2006; Meisami and Hasanzadeh 2012; Rahman 2010; Zarka 2012).

The integration of almsgiving into the microfinance system has some advantages. First, this model aligns the Islamic poverty alleviation spirit with self-employment and entrepreneurship, and the elimination of *Riba*. Second, the arrangement and modus

[11] It is important to note that the Almsgiving Law was introduced by the President Habibie who had led the ICMI. During the Suharto presidency, almsgiving was recognized by the government but it was not formally institutionalised through government regulation.

operandi of microfinance is likely to be effective to collect and manage almsgiving especially in community-based microfinance institutions. Third, the microfinance model has been proven as a sustainable poverty alleviation tool as it allows almsgiving and charitable funds to be leveraged in order to reach out to the majority of poor households in Muslim communities. In this regard, this study examines to what extent almsgiving and the Islamic poverty alleviation model has been successfully institutionalized in Islamic community-based microfinance in Indonesia.

2.2. Schools of Thought about Microfinance

Microfinance provides financial services with particular features and a distinctive mission to alleviate poverty. Microfinance has been in existence for over a century. It has evolved in response to changing political and socioeconomic circumstances and the advancement of technology. Microfinance has become an inclusive financial system with a broad range of services, methodologies and approaches (Meyer and Nagarayan 2006).

According to Ledgerwood (1999), there are two schools of thought concerning microfinance: minimalist and integrated. Although using different terminology, Woller et al. (1999) also identifies two schools: *welfarist* and *institutionist*. This discussion uses Woller's terminology.

The *welfarist* approach emphasizes that microcredit has the objective of supporting people who live below the poverty line. Microfinance provides access to loans that enable the poor to earn better income, as well as increase their capacity to save and own valuable assets, reducing their vulnerability through saving and asset building (Khandker 1998). In addition, with the provision of complementary skills training, literacy programs, health programs, nutrition and family planning, the poor are able to achieve a better standard of living (Robinson 2001). The pioneer of the *welfarist* microfinance approach was the Grameen Bank in Bangladesh (Versluysen 1999).

The *institutionist* approach argues that microfinance is the provision of financial services including microcredit, saving and other financial services that are designed to assist un-bankable micro-entrepreneurs in order to enhance their businesses to a point of becoming viable ventures that are eligible to access commercial bank services. This approach allows the microenterprise to progress, creates job opportunities in the community and invests more capital in new technology. Hence, in return, it would increase household income and foster local economic growth. One of the foremost examples of the *institutionist* approach is the BRI microbanking program in Indonesia (Robinson 2002)

By and large the two approaches to microfinance share the common objective of improving the socioeconomic welfare of poor inhabitants through productive economic activity: self-employment and entrepreneurship (Woller et al. 1999); however, the two camps have been in a debate about how microfinance programs should be delivered and managed (Murdoch 2000).

The *welfarist* framework argues that poverty is complex in nature and most of the poor and lower-income households are generally uneducated, unskilled, lack valuable assets, have no access to the market, are socially marginalized and their source of income is heavily dependent on low-waged seasonal subsistence agricultural labour. Thus, microfinance should be an integrated intervention, a mixture of concessional loans and social empowerment programs.

Zeller and Sharma argue that the underlying reasons why subsidies are imperative are, firstly, because it is a necessary intervention to ensure the poor can afford the microcredit. Through the interest subsidy mechanism, it provides the poor borrower with the opportunity to save their remaining income for other essential needs including as a safeguard against unforeseen expenditure. Secondly, public aid to the microfinance sector within the context of the antipoverty policy is acceptable because it is used to recapitalize the microfinance program. The subsidy is akin to a social safety fund that should be allocated to assist the poorest inhabitants (Zeller and Sharma 2002).

In addition, Woller et al. (1999) emphases that the *welfarist* approach focuses on depth, outreach and the impact of microfinance intervention to the poorest of the poor. Subsidy-based microfinance reaches out to the destitute segment and uses group-based lending methodologies to organize poor borrowers of similar socioeconomic and cultural backgrounds. This approach allows the microcredit and empowerment program to be managed under a ‘one size fits all’ strategy and effectively to involve a great number of poor clients in communities. Woller et al. (1999) argue that microfinance services should be directed to smooth the irregular pattern of income of the poor so that they could maintain regular household consumption and more specifically to empower woman as central actors in the family structure. With an effective intervention mechanism, the microcredit scheme could generate positive impact on the economic wellbeing and self-esteem of the poor.

In contrast, the *institutionist* approach focuses solely on providing diverse financial services and underlines the importance of sustainability of the microfinance program. For this reason, the microfinance scheme is designed to reach out to creditworthy clients who are able to repay the loan at a commercial interest rate. In turn, the interest payment would be sufficient to cover operational expenses and generate profits to sustain the microfinance programs in the long term and reach out to poorer clients. In other words, financial sustainability and robust performance are the primary objectives of this approach (Robinson 2001).

Under the *institutionist* approach microfinance is a function of the financial intermediary system that allows surplus funds from the commercial market to be channelled to the microenterprise sector in suburban and rural areas. The flow of microfinance money would foster local economic growth and break down financial exclusion. In addition, the model uses an individual lending methodology to fit in with specific client characteristic and offers saving and deposit services in order to mobilize local sources of funds for its operation as well to extend the financial services into different poor communities that are not tapped by the formal banking system.

2.2.1. Microfinance Discourse and a Way Out

To some extent, the differences between these two approaches reflect the dilemma of microfinance. On one hand, the *institutionist* proponents, i.e. Robinson (2001) argue that microfinance, in the long term, would not be sustainable if they neglected market mechanisms and became dependent on subsidies to cover their operational costs. In the current situation, many microfinance programs have collapsed or been transformed into for-profit institutions because the subsidy dried up. Instead the governments in developing countries and donor agencies shift their policies to assist the poorest through the social security system and invest in education, hospitals and other basic infrastructures to broaden economic opportunity in high poverty incidence areas.

On the other hand, the supporters of the *welfarist* model, for instance Yunus and Jolis (1998), assert that commercial microfinance would drift away from the noble objective of poverty alleviation and focus on bankable clients and benefit investors rather than to reach the poorest segments of society. Recent evidence, i.e. Charitonenko et al. (2004) suggests that huge commercial funds flowing into the microfinance sector have driven many microfinance institutions to be more profit oriented. The microfinance services seem to be growing significantly in urban areas rather than expanding into rural areas, and providing more consumer credit instead of lending to productive microenterprises. Research in Latin America demonstrates that many poor borrowers are over-indebted as they have taken out several loans from different microfinance providers (Gonzales and Gonzales-vega 2003).

It is likely the debate is counter-productive to the poverty alleviation movement if there is no way to resolve the differences. Outside the debate, many microfinance scholars propose a win-win solution and a compromise policy, which includes a new microfinance methodology.

Firstly, Takahatake and Maharjan (2002) propose that *welfarist* microfinance should be an integral part of government socio-welfare programs, in particular to ensure that the destitute population could access financial services in addition to social security benefits. In this regards, Robinson (2001) underlines the importance of adopting a ‘poverty alleviation tool box’ as a strategy guiding the development of comprehensive anti-poverty policy.

Second, Becchetti (2010) asserts the need to break down subsidy policies into three schemes:

1. A direct interest rate subsidy to the poorest borrowers;
2. An operational subsidy to cover the operational costs of microfinance institutions that serve the poorest borrowers;
3. A guarantee fund to broaden financial access to un-bankable borrowers who lack collateral to start up a microenterprise.

Aghion and Morduch (2005) suggest smart subsidies for anti-poverty microfinance programs. The subsidy should not interfere with the market mechanism, but rather provide technical assistance in order to strengthen institutional and human resource capacity.

Third, Bangoura (2012) proposes a compromise solution between the mission to reduce poverty and sustain financial performance. In this context Woller et al. (1999) support the need of both microfinance camps to embrace social enterprise concept as a new model to achieve double bottom line objectives: profit and social impact. In addition, the Centre for Financial Inclusion (CFI) argues that microfinance system should embrace good governance and responsible lending practices, and be more transparent in setting loan interest rates, fees, terms and conditions in order to protect poor clients against excessive commercialization and over-indebtedness (CFI 2011).

Finally, Aziz (2004) argues that the faith-based microfinance should be considered as an alternative way to solve the dispute and dilemma between sustainability and poverty alleviation. The unique arrangement of the Islamic microfinance is likely provide dual mechanism to alleviate poverty, and empower the poor to be independent and productive (Rahman 2010; Sultan 2012). This approach is critically examined in this study: How does the Islamic microfinance system function in local communities? How it could play a role as the alternative microfinance model?

2.3. Islamic Microfinance Principles

The idealistic concept of Islamic microfinance is akin to the conventional financial model, which is to broaden financial access to the poor, who are not served by the formal banking system. However, it differs in one core principle because Islamic microfinance is subject to Islamic Law (*Sharia*).[12] The main feature of the *Sharia* legal system as it applies to finance is that it proscribes *Riba*.

2.3.1. Definition of *Riba* and Prohibition of Interest

The underlying prohibition of *Riba* is stated in the Holy Quran. The term and its nature are revealed in several verses, including reasons why it is strictly banned (Saeed 1999). As discussed in the previous section, the technical meaning of *Riba* is 'an increase' that

[12] The terms *Shariah* or *Syariah* are interchangeable. It originates from the rules that were dictated in the Holy Quran and *Sunnah* – the teachingss, practices and explanations rendered by The Prophet Muhammad.

is generally associated with the economic, banking and financial systems. In a specific description, *Riba* occurs when, on the top of principal capital or loan, there is an additional amount of profit.[13]

In the Holy Quran, *Riba* is mentioned in different contexts during the prophetic period, hence it results in several interpretations (Al-Harran 1993). First, *Riba* is associated with the moneylender tradition in the pre-Islamic period. The practice of usury is categorized as *Riba al-Nasiah*, which refers to lending money with excessive interest payments; usually this 'loan shark' practice is directed toward the poor (Saeed 1999). This type of *Riba* also refers to 'incentive for waiting'; in the modern financial system it is called the time value of money. The second type of *Riba*, *Riba al-Fadl*, is a return that is related to trade and commerce (e.g. commodity exchange) and a loan in kind (Lewis and Algaoud 2001). A detailed description of *Riba* is presented in Table 2.1.

Table 2.1. Classifications of *Riba* in Economic Transactions

Type of *Riba*	**Translation**	**Application**
Al Nasiah, *Al Jahiliah* or *Al Qurud*	Usury of waiting or time value of money	Involves a delay in an exchange of counter values, i.e. deferral of payment with additional profit; lending money with interest.
Al Fadl or *Al Buya*	Usury of incremental (surplus)	Increment of an exchange of counter values, i.e. one piece of gold to be given now in return for two pieces of gold to be received later; involves a non-monetary transaction (commodities) exchange of unequal amounts of the same type, i.e. an amount of good-quality dates is traded for a larger amount of poor-quality dates.

Source: El-Diwany (2010)

In the context of Islamic economics, usury, in particular the interest concept, and other illicit trade and commerce transactions, are prohibited because:

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[13] The general concept in Islam in gaining profit is through trade, commercial transactions and productive investment. In this context, 'commerce' should be understood in the broader economic sense, since there are many business activities involved, for example, production of commodities and goods, logistics and transportation, sales and marketing, employment, financial transactions and other related contracts. However, commerce becomes unlawful (*Haram*) when there is any element of unjust, exploitative, speculative, deceitful or corrupt practices revealed. In addition, trade involving pigs, alcohol, drugs and narcotics is regarded as *Haram*.

- Interest has an exploitative element that allows wealth accumulation in the hands of a limited number of individuals and/or economic institutions. Evidence shows that since early civilization, interest was a means for rich people to gain advantage from the poor. In other words, the interest-based system would create a huge socioeconomic disparity between the rich and the poor (Ayub 2008). This thinking is also evident in Judaism and early Christian teachings (Homer and Sylla 1991).
- Interest related to the time value of money discourages an innovative spirit and hard work since a financial return can be generated from unproductive activities like hoarding and speculative business rather than investing in the genuine economic ventures that promote growth, job opportunities and prosperity.
- Pre-determined interest allows one party (i.e. the investor) to earn bigger profits without sharing risk and equal effort, thus eventually it would create unjust and unethical behaviour (Al-Harran 1993).

Despite the prohibition of *Riba*, many Muslim clerics express different opinions in understanding the nature of *Riba* when it applies in the context of the modern banking and financial system. The mainstream dispute about *Riba* is represented in traditionalist and modernist views (Lewis and Algaoud 2001; Saeed 1999; Vogel and Hayes 1998). The first view claims that *Riba* should be in understood as stated in the Holy Quran and the Prophet's teachings, therefore all forms of interest must be eliminated from the economic and financial system (Ayub 2008). The proponents of this traditionalist approach argue that Muslim society should build its own model rather than operating as a subdivision of the conventional banking and financial system.

However, the modernists assert that *Riba* should be also viewed as a moral-spiritual principle especially in responding to the dynamic change occurring in Islamic economies and societies (Saeed 1999). The supporter of the moderate interpretation of *Riba* argues that the interest-based financial approach is acceptable if it is not excessive in nature and if the objectives focus on poverty alleviation and financial inclusion, and if the approach contributes to development in the society. In particular cases where only the conventional system is available, it would be permissible under emergency or certain conditions (*Darurah*). This view also demonstrates a compromise approach by adopting a dual model that enables the Islamic banking and financial operations to exist in conjunction with the conventional approach.

In Indonesia, for many years, the *Riba* interpretation has been a controversial issue among traditionalist and modernist scholars (Antonio 2004; Effendy 2003). According to Antonio (2004) the discourse of *riba* among the mainstream Islamic organisations such as Muhammadiyah, NU dan MUI dated from the colonial period, but the issue did not gain momentum since the organisations were more focused on education, economic and social activities. After the establishment of Bank Muamalat Indonesia (BMI) in 1991, the discourse of *riba* emerged however, due to political concerns, Muhammadiyah, NU and MUI were inclined to compromise that interest rate is *riba* but the practice of conventional banking was categorised permissible as long as the bank does not charge an excessive interest rate. In this case, Muhammadiyah and NU supported the establishment of conventional banks in order to provide financial services to their members. A similar view also demonstrated by MUI that interest rate of conventional bank could be accepted under a specific condition, i.e. emergency situation (*Darurah*) in which no Islamic banks were accessible. Accordingly, after the collapse of the New Order government, the majority of Islamic organizations reached a consensus that payment of interest is *Riba* and not permissible for Muslims to engage in the interest-based transactions. Officially, the Islamic National Council (*Majelis Ulama Indonesia* or MUI) declares interest is *Riba* through a nonbinding edict (*Fatwa*) No. 1/2004. Broadly speaking, many Muslims accepted the edict, but continued to borrow money from conventional banks because this was a long-established practice and there were limited practical alternatives (Antonio, 2004). Some Muslims use both conventional and Islamic banks, while a smaller number permanently switched to use the Islamic banking system. In this debate, the government has sought to accommodate the call of Muslims by adopting a dual banking system. In 2008, the Islamic Banking Law was introduced in order to provide a legal framework and equal playing field for the faith-based banking and financial sector to grow (see discussion in Chapter 6).

2.3.2. Financial Methodology and Products

In accordance with the earlier discussions, Islamic microfinance preserves its own inherent characteristics in delivering financial services (Dhumale and Sapcani 1999). Therefore, its modus operandi, including the organisational arrangements, operational procedures and features of products, are governed by the *Sharia* compliance framework (Ali 2012).

Primarily, Islamic microfinance is an interest-free financial system in all of its products and transactions; however it allows profit generation through risk and revenue or profit and loss sharing mechanism (PLS). Equally, speculative businesses and transactions are prohibited (*Gharar*). The principle of the transaction must be linked to the actual and identified underlying business and/or tangible assets. In addition, it cannot deal with several kinds of business (*Haram*), mainly gambling, pornography, drugs and alcohol, pork, and other unacceptable conduct including dishonest, deceptive, corrupt and unjust practices (Abdul-Rahman 2010; Obaidullah 2008).

The core financial methodology of Islamic microfinance is PLS. There are two generic models of PLS: *Mudaraba* and *Musaraka*. The scheme works under mutual partnership (*Sirka*) between the depositor or investor (*Rabb al Maal*), Islamic microfinance institution (*Baitul Tamwil*) and borrower (*Mudarib*). The most common PLS mechanism is where the depositor or investor places some amount money into saving or deposit account, accordingly the institution manages the fund and also search for qualified borrower with a commercially viable business venture that can be financed. In return, all parties share the profit that is generated from the business or share the loss if the business is a failure. In addition, usually, the parties set a proportion (ratio) of profit and loss sharing in advance, but it is not allowed to state a pre-determined rate of return (exact value) and/or fixed profit that commonly practised in the conventional system (Lewis and Algaoud 2001).

Equally important, Islamic microfinance also uses trading (*Murabaha*) and leasing contracts (*Ijara*) to generate profit. These models are less complicated compared to the PLS modes and the transaction arrangement seems quite similar to the conventional system of contracts. To understand the thorough nature of Islamic microfinance, the following discussions explain how the methodologies are applied into funding and lending instruments (Obaidullah 2008).

2.3.2.1. Funding Mobilization

The funding source of Islamic microfinance comprises public saving and deposit, equity, borrowing from other financial institutions, government subsidies, donor grants, and almsgiving and charitable donations (Obaidullah 2008). Among those, saving and deposits are the most important features in the liabilities structure and the primary liquidity pool for lending and investment activities.

There are two types of saving and deposit arrangements. First, a trust account (*Amanah* or *al Wadia*), in which the contract stipulates that the depositor entrusts the funds into a zero-yield account, but it should be risk-free and can be withdrawn at any time. The nature of a trust fund encompasses two categories: a safekeeping account and a current account. The first type cannot be invested by the institution but allows the charging of a fee for the safekeeping service (Khan 2008). The latter account is very liquid and in many cases can be allocated into very short-term and secure investments in order to minimize idle funds, hence it can provide a bonus to motivate a client to invest the money over a longer period.

The second type is a PLS-based *Mudaraba* account in which the contract normally applies to a passbook saving, term deposit, investment account and special investment account. The general term of agreement is set in advance, for instance, the ratio of return and risk sharing, maturity, service fee and penalty. However, for special investment accounts, the contract also states in detail the peculiar right and obligation of each party in order to ensure the contract is fully binding under the *Sharia* compliance system (Obaidullah 2008). Technically speaking, the PLS account is the most dominant source of funds for Islamic microfinance as it can be invested in riskier and long-term projects that generate greater profit.

As its concept is based on religious tenets, Islamic microfinance commonly mobilizes almsgiving and charity donations as well. The funds are mainly allocated to support the mission to alleviate poverty and socio-spiritual empowerments hence it has separate accounting and reporting systems that ensure a clear division between the non-profit and commercial objectives (Rahman 2010). Recently, almsgiving management has been developed so that some portion of undisbursed funds (e.g. donations) could be invested into productive, but less risky, ventures in order to enhance its capacity to reach out to poorer segments of the population and develop religious philanthropic programs (Sultan 2012).

2.3.2.2. Lending or Financing Techniques

Lending instruments for Islamic microfinance are adopted from Islamic banking practices, however there is significant adjustment to the methodologies in order to fit with the modus operandi and the client characteristics of microfinance (Obaidullah 2008). Lending modes encompass several types including a partnership contract

(*Mudarabah* and *Musarakah*), a trade/sale contract (*Murabahah*), a lease contract (*Ijarah*), and a benevolent loan (*Qard Hasan*). It is also worth noting that recent developments show Islamic microfinance has adopted several new *Sharia*-compliant products from the Islamic banking sector, for example pawn (*Rahn*) and insurance (*Takaful*), however, these instruments are not discussed in this study.

The *Mudarabah* partnership is common in Islamic microfinance. The scheme occurs when funds are invested into a business venture, where the borrower is the client and the funds are regarded as a loan. Technically, the PLS model states that the financier provides the capital and the client has the expertise. In return, both parties agree to distribute the profit, but if there is loss, the financier will bear the financial risk and the client bears the cost of the labour and effort. In the partnership, the client solely manages the business venture but normally the financier periodically monitors the venture to ensure the business is performing well. The contract should not stipulate a guarantee that the business will generate profit, however, if there is loss due to misuse or fraud, the client should be responsible for the whole invested fund (Saeed 1999).

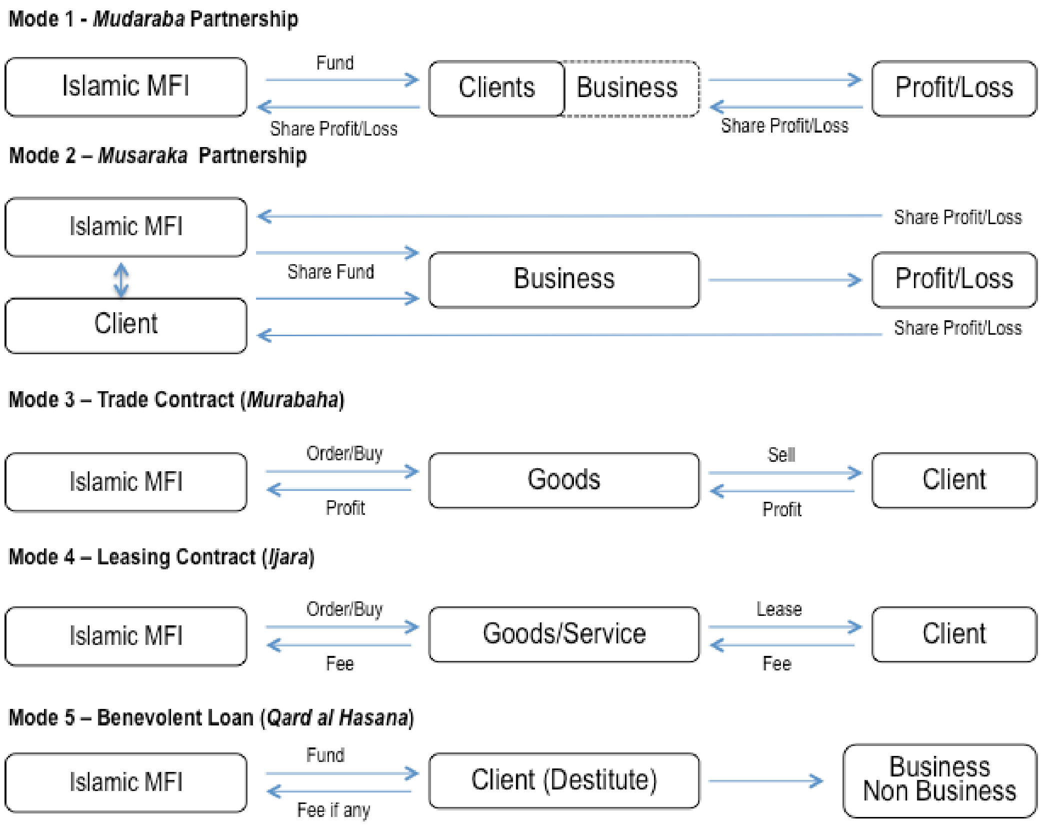
The second type of partnership financing is *Musarakah*. In this contract, the Islamic microfinance institution and the client form a mutual partnership in capital and management of a particular enterprise. In contrast to the previous mode, the financier and client are responsible for decision-making, daily operations and overall business performance. In general, the company is led by the party that invests bigger capital or the majority shareholder. The contract allows the parties to own an equal share, or one party acts as the majority investor. In effect, this position will determine the ratio of profit and loss that should be distributed to the financier and the client. In addition, the nature of the partnership can be permanent, or one party (e.g. the financier) may gradually transfer their share to the client partner (Lewis and Algaoud 2001).

The *Murabahah* concept is a trading or sales contract in which the role of the Islamic microfinance institution is as the seller, and the client is the buyer. Initially, the client requests the financier to provide particular goods, assets or commodities. Based on the agreed terms and conditions, for example – goods specification, principal price, margin, delivery and payment method – the financier searches and buys the goods then directly delivers to the client. The financier adds an amount of profit on top of the basic price and the payment can be cash or under a deferred system for a certain period. In the case of deferred payment, the instalment should be set proportionally toward the basic price (principal) and profit. The contract appears quite similar to traditional credit term payment but the profit should not be regarded as interest (El-Diwany 2010).

The *Ijarah* method is basically a leasing arrangement in which the financier rents the required assets, property or services to the client. For this service the institution charges a fee for the period of the rental contract. There are two types of leasing contract. The first is a generic lease in which the client uses the object property; when the contract is due the property should be returned to the financier lessor. The second type is a lease-purchase scheme in which at the end of the agreement the ownership rests with the client. Typically, during the lease period, the financier bears the risk of damages and maintenance cost, and in return, the client pays a fixed fee regularly or makes a lump sum payment (Lewis and Algaoud 2001).

The uniqueness of Islamic microfinance is that it integrates a social-religious mission in its financial instruments through a benevolent loan model (*Qard Hasan*). The primary feature of this scheme is charity loan with a very low return, or in some instances, it is free of charge. The loan finances start-up and on-going microbusinesses, to support income equalization of poor households, and other social purposes. In association with the loan, there is also provision of technical assistance and coaching, mentorship and a spiritual empowerment program in order to ensure the loan performance and to generate significant benefit to the recipient. The main source of funding is from external philanthropic and lending institutions as well as government grants. The practice of benevolent loans is separate from commercial activities; if the loan generates a return, it should be reinvested into the charity program (Khan 2008; Rahman 2010).

Figure 2.1. Islamic Microfinance Lending Modes



Source: Author compilation from Saeed (1999), Lewis and Algaoud (2001)

2.3.3. *Sharia*-Compliant Framework

As mentioned in the previous discussion, the Islamic microfinance system is governed under the *Sharia*-compliant system. Consequently, any practice and conduct that violates the *Sharia* is deemed unacceptable and sinful. The operational guidance of *Sharia*-compliance is based on a *Fatwa* published by a legitimate Islamic organisation, scholar, cleric or other religious patron.[14] A *Fatwa* is an elaboration and translation of a verse of the Holy Quran, *Sunnah* and/or other jurisdictions regarding the economy, trade and commerce and financial intermediary activity. Basically, a *Fatwa* explains in detail the *Sharia* jurisdiction, philosophy, consideration, and general operational guidance in conducting a financial contract and transaction (IRTI 2008).

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[14] In Islamic countries such as Iran, Malaysia and Sudan, there are *Sharia* supervisory boards that are responsible for publishing and reviewing *Fatwa*. In Indonesia, the authorized agency for publishing *Fatwa* is the National *Sharia* Board (DSN), an independent organisation of the Indonesia Islamic Scholar Council (MUI). Its membership consists of clerics, regulators, economists, legal experts, academicians and practitioners.

Grais and Pellegrini (2007) points out that to ensure and oversee that the Islamic microfinance operation complies with the *Sharia* principles, there is to be a *Sharia* supervisory board (SSB) established within the organisational structure. Ideally, the board comprises of members who have expertise in the *Sharia* law as well as in economics, trade and finance. Legally, the *Sharia* boards should be approved by the regulator.

The function of the board is to determine, independently, whether the financial procedures, contracts, and transactions are *Sharia*-compliant. The nature of assessment is through a comparative approach by evaluating the factual evidence in relation to the *Fatwa*, and in the final report there should be a conclusive statement of whether the institution is fully *Sharia*-compliant, or partly compliant when to some extent there is a specific *Sharia* issue that needs to be addressed by the management, or a disclaimer due to breaching the *Sharia* compliance framework.

In research conducted by the Islamic Research and Training Institute of the Islamic Development Bank, it was found that many Islamic microfinance institutions lacked *Sharia* supervisory boards in their institutional organisational structures. This reflects the fact that many Islamic microfinance institutions are informal in nature and only in a few instances are part of an Islamic bank. In addition, often the Islamic microfinance management, *Sharia* board members and regulating agency demonstrate different opinions in understanding the nature of transactions as a result of divergence between Islamic schools of thought and lack of a standardized assessment manual (IRTI 2008).

2.3.4. Development of Islamic Microfinance

Islamic microfinance has been developed in major Muslim countries. The Islamic microfinance programs demonstrate wide variations in institutional arrangements and methods. For instances, the Islamic Bank Bangladesh provides Islamic microfinance service under a rural development program. The approach is solidarity-based lending to women which was adopted from the Grameen Bank model to enhance the rural economy and eliminate widespread poverty and destitution (Rahman 1999). In Bosnia Herzegovina, the Islamic Relief organisation introduced benevolent loans for housing and partnership financing for the microenterprise sector (Khan 2008). In Sudan, the Islamic microfinance approach is designed to provide venture capital to foster the microenterprise sector (Harper 1994) and the Islamic bank of Sudan uses the Islamic-based lending instruments to alleviate rural poverty (Ibrahim 2003). The international Islamic Aga Khan organisation Agency for Microfinance has established Islamic microfinance institutions in rural Pakistan. In Indonesia, Islamic microfinance systems use a mixed strategy of charity and commercial approaches (refer to discussion in chapters 7, 8 and 9).

There is evidence that demonstrates that the Islamic microfinance system provides a promising pathway to achieve a better Muslim society. The Islamic anti-poverty concept, through the provision of integrated Islamic microfinance instruments, fosters the local economy, job creation, entrepreneurial movement and community participation (Dhumale and Sapcani 1999). Obaidullah (2008) points out that the dynamic role of Islamic microfinance helps alleviate chronic poverty by employing charitable and economic development.

The philanthropic approach focuses on basic essentials and mitigation of the vulnerability of the needy, the ill and unemployed. Then the assistance seeks to generate household income through providing benevolent loans for poor people who are in the productive age groups. Subsequently, at certain economic levels, poor people are encouraged to access commercial microfinance services to enhance their businesses, productivity and profitability. It is evident that this approach could improve incomes, nutrition, saving and asset building, children's education, social status and overall family welfare. Also, the multiple objectives and methodologies of Islamic microfinance allow the lending institutions to focus on different segments of the poor and sustain their financial performance without burdening the government budget or becoming dependent on donor subsidies (Kaleem and Ahmed 2010; Rahman 2010).

In addition, according to Khan and Thaut (2011), the salient characteristics of Islamic microfinance demonstrate various advantages that could be adopted by the conventional microfinance system. First, in relation to economic partnerships, financial contracts and debt, Islamic teachings emphasises that Muslims must fulfil promises and obligations. This religious concept could eliminate moral hazard[15], in particular to reduce default by

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[15] Moral hazard is actions of economic agents to maximise their own utility to the detriment of others in situations where they do not bear the full costs or consequences of their actions (Alexander 2006, p.18).

borrowers. Subsequently, it could improve the rate of loan repayment and sustainability of the system.

Second, the PLS model allows investors and borrowers to share equal or proportional responsibility, expertise, time and commitment toward the success of the business. The system also creates incentives for each party to conduct good governance and to maximize returns.

Third, the Islamic microfinance system only allows loans to be directly used for productive purposes in order to gain an immediate return and maximize the use of funds for enhancing economic turnover. Also the diverse kinds of financial instruments would reach a wider range of clients. Chapra (2006) asserts that the *Mudarabah* and *Musarakah* financing modes allow the poor entrepreneur, who lacks collateral, to obtain capital, and also in the case of genuine business failure or situations beyond the control of the borrower, hence the borrower would not bear the burden. The *Murabahah* and *Ijarah* contracts are associated with real assets and/or businesses and reduce the risk of misuse of funds for consumption.

Fourth, benevolent financing is relevant for breaking the cycle of poverty and enables the needy and the very poor to become involved in the productive economy with little or no liability to repay the loan if the ventures fail. In addition, the donated funds could be leveraged for a credit guarantee scheme that will both protect the financiers' investments and would provide marginal borrowers access to financial services (Chapra 2006).

Finally, the faith-based microfinance principle is based on Islamic moral and ethical standards that would promote egalitarian outcomes, equality, generosity, benevolence, and simultaneously prohibit immoral conduct and other unlawful behaviours. In general, the system drives prosperity, social harmony and unity in the community (Iqbal 2002)

In spite of strong commitment and motives, Islamic microfinance inherently faces some challenges:

- The dominant source of risk is in the PLS mechanism which deals with the problem of agency. This problematic financial relationship could lead to moral hazard and default.
- The bundling process of PLS-based microfinance is inclined to increase operational costs to implement the contract as well as the cost of monitoring. These factors could affect profit margins.
- As Islamic microfinance is in its initial development phase, typically it lacks innovative products, is inefficient due to small economies of scale, it encounters a shortage of capable human resources, as well as facing negative criticism from some elements of Muslim society that particular products are similar to interest-based microfinance.

Table 2.2. Comparison of Microfinance Schools of Thought

Approach	Parameter	Description
Islamic based	• Objective	• Poverty alleviation through socioeconomic and religious empowerment: Provision of basic essentials for the destitute; Benevolent loan for household-based microbusiness; Loan to advance productive activity and commercial purposes; Technical assistance and socio-religious empowerment; Financial inclusion.
	• Modus operandi	• Islamic financial model but not allowed to own conventional system unit.
	• Source of funds	• Commercial (saving, deposit, commercial loan); Subsidy (government, donor grant); Almsgiving and donation.
	• Methodology	• Profit loss sharing: saving/deposit, and lending: PLS partnership contract, trade/sale contract, leasing, benevolent loan.
	• Organisation	• Board of management; *Sharia* supervisory board.
Welfarist	• Objective	• Poverty alleviation through socioeconomic empowerment including: Loan for income smoothing and household-based microbusiness; Technical assistance and empowerment.
	• Modus operandi	• Conventional model but allowed to own faith-based system unit.
	• Source of funds	• Subsidy (government, donor grant); Donation (philanthropic fund).
	• Methodology	• Interest-based transaction: compulsory saving, and group lending.
	• Organisation	• Board of management.
Institutionist	• Objective	• Poverty alleviation through economic empowerment. Loan to advance productive activity and commercial purposes; Financial inclusion.
	• Modus operandi	• Conventional model but allowed to own faith-based system unit.
	• Source of funds	• Commercial saving, deposit, commercial borrowing.
	• Methodology	• Interest-based transaction: saving and deposit, and individual lending.
	• Organisation	• Board of management.

Source: Dhumale and Sapcani (1999), Woller et al. (1999), Murdoch (2000).

2.4. Sustainability and Dilemmas of Microfinance

Sustainability has been an emerging issue in discussions about the development of microfinance schemes. The issue arises since subsidy-based microfinance failed to sustain the mission of alleviating rural agricultural poverty. Researchers have attempted to develop a new microfinance paradigm that could be sustainable (Robinson 1995) and, equally important, to address how to measure the sustainability of the model (Yaron and Benjamin 2002).

'Sustainability' means 'perpetuity' (Navajas et al. 2002) and it reflects a long-term perspective. By definition, sustainability is the capacity of microfinance institutions or programs to provide services over the long term and maintain healthy growth without external financial support, including subsidies, grants and concessional funds that can be accessed by the institution at lower prices or below the market rate (Ledgerwood 1999). In other words, sustainable microfinance should be commercially profitable.

Rosenberg et al. (2009) argue that, theoretically, microfinance could achieve sustainability by providing financial services that generate revenue in excess of costs. Accordingly, to generate the income, microfinance institutions should charge interest rates and associated fees to clients who borrowing money at a sufficient level to cover the cost of lending and other operational expenses, such as cost of mobilizing savings and deposits from public, and other commercial funds, administrative costs and losses due to bad loans.

According to Ledgerwood (1999), the commercial interest rate is a leading determinant to sustain microfinance operations, and in this regard the client should be able pay the price for the loan. In the Islamic microfinance system, sustainability is determined by the proportion of PLS between the financier and the client, and the mark-up price (Obaidullah 2008). However, as previously discussed, charging a commercial interest rate could undermine the mission of microfinance to alleviate poverty (Woller et al. 1999), because higher interest rates are a huge burden for poor borrowers who, naturally, only earn limited incomes, and in many cases their incomes are insufficient to support their living. Thus, this view opposes the practice of commercial microfinance, with its imperative of financial sustainability, because it perpetuates the incidence of poverty (Khandker 1998).

Interestingly, empirical studies demonstrate that the vast majority of microfinance institutions set interest rates above the commercial bank rate (Rosenberg et al. 2009). The underlying explanations to justify the higher rates are: First, the high cost of the fund. As revealed in several studies, for example Meyer and Nagarayan (2006), many microfinance providers are not self-funded because of limited capacity to mobilize public savings and deposits. Instead, they rely upon commercial borrowing from local banks and international investors that are expensive sources of funds. The high cost of funds will accordingly be directly converted into higher a lending rate (Hamada 2010). Secondly, another leading determinant is the higher overhead cost to process loan applications and to perform monitoring of the microcredit portfolio, compared to portfolios of larger loans. Third, it is worth noting that the typical return of microenterprises is slightly higher than the return for larger enterprises, which makes it more acceptable for the borrowers to pay higher interest rates in return for repeat access to bigger credit advances.

Sustainability is driven by loan quality (Ledgerwood 1999). The basic indicator of microcredit performance is to what extent the client regularly repays the loan within the agreed schedule. Late payment of instalments leads to loan default that affects the income stream and possibly becomes a loss if the loan quality deteriorates into bad debt. Thus, clearly inadequate income creates financial turbulence and is eventually unable to sustain the operation. To maintain the performance of the loan portfolio, many commercial microfinance programs employ sophisticated loan collection and monitoring systems, including requiring collateral from the borrowers to secure the loss from loan default.

As mentioned in the previous discussion, the nature of microfinance operation involves relatively high overhead costs compared to the banking sector, thus efficiency is another marker of sustainability. In the study of microfinance in Lombok, Indonesia, Budastra (2003) summarizes three categories of efficiency that are associated with microfinance sustainability: first, a lower transaction cost (operational efficiency), second, effective credit allocation (allocation efficiency) and third, competitiveness (dynamic efficiency). Moreover, in practice, a microfinance institution should embrace the concept of simplicity (Robinson 2002) through streamlining procedures and organisation, faster decision making, maintaining high productivity and continuous innovation.

The formulation of sustainability in microfinance has been discussed for many years, for example, Yaron and Benjamin (2002) suggest that sustainability is a subsidy dependence index which measures the amount of financial (quantifiable) subsidies received against interest earned by microfinance institutions.

More recently, there have been several methodologies developed to measure the soundness of microfinance institutions, and each method has its own specific standards and objectives. Arsyad (2006) summarizes four methodologies of microfinance assessment, for instances the ACCION-CAMEL uses capital, assets quality, management, earning and liquidity indicators to assess microfinance performance. The MICRORATE model emphasizes key risk areas such as lending operations and portfolio quality, organisation and management information system, and financial performance. The M-CRIL focuses on 30 indicators covering three main areas: organisational and governance aspects, managerial and resource strength, and financial performance. The GIRAFE (Planet Rating) scrutinizes 26 indicators grouped under governance, information and management tools, risk analysis and control, efficiency and profitability. In addition, the Microfinance Information Exchange (MIX) of the Consultative Group to Assist the Poorest (CGAP) employs a peer assessment model by using various types of financial ratios of microfinance institutions that have reported for at least four consecutive years (MIX 2009).

A specific model to examine the sustainability of cooperative institution was developed by the World Council of Credit Unions (WOCCU). The PEARLS monitoring system incorporates 45 financial ratios that encompass protection, effective financial structure, asset quality, rates of return and costs, liquidity and signs of growth (Richardson 2002). Furthermore, in Indonesia, assessment of the BMT sector is formally carried out by the MENEGKOP-UKM, the provincial or local cooperative department, based on government regulation No. 91/2004, and a method of measurement similar to the CAMEL model (MENEGKOP-UKM 2008).

In the early stages of development of the microfinance sector, the sustainability concept is perceived as a pathway of the microfinance institution to be financial viable; from being heavily dependent on external assistance, it then gradually becomes partially subsidized until it reaches a stage of healthy performance (Rhyne and Otero 1994). Recently, the sustainable framework has been developed into two categories (Ledgerwood 1999). First, operational self-sufficiency (OSS), which can be achieved if earned income surpasses operating expenses. In other words, the OSS indicator determines to what extent the microfinance institution earns profit. Thus, a positive OSS ratio suggests the institution has successfully reached an initial stage of sustainability;

conversely, a negative OSS ratio is a sign of unsustainable operations that eventually would reduce the equity in order to cover operating losses.

The second category is financial self-sufficiency (FSS), which is a broader measure than OSS as it includes inflation and subsidy factors. FSS demonstrates that a microfinance operation is profitable and is able to maintain the value of equity, that is, it is fully sustainable. This study uses this concept in examining the performance of Islamic microfinance. (The formulation of the calculation is explained in Chapter 3.)

2.5. Summary

This chapter reviews a number of relevant theories and empirical studies about the complex nature of poverty and its intersection with Islamic tenets and microfinance concepts as a means of empowering the poor. It is evident that poverty alleviation is a religiously motivated endeavour and every effort to eliminate destitution would be rewarded in the hereafter life.

Poverty alleviation involves multi-dimensional strategies through socio-spiritual and economic instrument programs, and, more importantly, requires the active participation of the community. In this respect, Islamic teachings demonstrates a clear pathway of how to integrate the elements into systems and mechanisms that were established by the Prophet Muhammad in the early period of Islamic civilization.

In addition, Islamic doctrine emphasizes the importance of moral and ethical principles by strongly prohibiting exploitative and unjust behaviour, since such behaviour would create social disharmony and inequality in the distribution of economic resources. However, Islam allows a profit system as a reward for hard work, effort and risk-taking. The model of Islamic economics and finance, in particular Islamic microfinance, is not only Table relevant to commercial factors, but it is also used to achieve a social mission as it has distinctive attributes that can be employed in anti-poverty and financial inclusion programs. The following chapters discuss the theoretical framework used in examining the dynamic roles of BMT as an Islamic community-based microfinance institution. They will consider questions such as how it conducts the poverty alleviation mission, and to what extent it is sustainable.

CHAPTER 3

RESEARCH APPROACH AND METHODOLOGY

The initial idea for this research had its origins in my discussions with the former Executive Director of the Dompet Dhuafa Foundation (DD), the Chairman of the BMT Center (BMTC) and the Director of Permodalan BMT (PBMT).

This chapter discusses the research framework and methodologies that are used and how the study of the BMT system in Yogyakarta was conducted. In general this study adopts a similar approach to an earlier study of LPD in Bali, in which the establishment, operations and its sustainability of the lending institutions was inherently influenced by Balinese customs and culture, and by Hindu traditions (Arsyad 2006). However, in this study, the primary aim is to examine the phenomenon of the BMT institutions that employ an Islamic microfinance approach in the Javanese Muslim context, as well as to assess the suitability of interest-free microfinance practices in the local economic setting that are dominated by an informal sector, microenterprises and agriculture-based activities.

This chapter explains the research approach, research site and timeframe, sampling design, selection of respondents, data collection techniques, data processing and validation. In the data analysis section, the discussion focuses on the methodologies employed in collecting and analysing the data and how these datasets and findings are organized and presented in order to address the research questions and objectives. In addition, the chapter discusses the methodology that is used in examining the BMTs' performance and sustainability.

It is important to note that during the field studies the researcher encountered many constraints and challenges; in effect, there were several adjustments made to accommodate the dynamic research process. Overall, the research successfully collected the main data and information from primary and secondary sources.

3.1. Research Approach

Microfinance has attracted much research interest and many studies have been conducted to understand the phenomena through various research designs and methodologies. Distinctively, this study explores the dynamic role of BMTs as Islamic-based microfinance institutions, and examines to what extent their operations influence the socio-economic and spirituality circumstances in the Muslim communities in Yogyakarta and, in particular, assesses their performance and sustainability in the framework of poverty alleviation. Compared to other provinces such as West Java, East Java and Jakarta, the BMT sector in the Yogyakarta region is more dynamic and has grown rapidly. In many instances, BMTs in Yogyakarta, like BMT Beringharjo is widely used as a model by other BMTs, including as case studies for academic studies (Sakai 2008 & Sakai 2010). Given the nature of the study, the research employs a mixed method research technique and analysis based on a case study model.

3.1.1. Mixed Method

The research used the mixed method approach, in which qualitative and quantitative methodologies were employed to acquire data regarding the BMT sector in order to address the research questions. According to Creswell and Clark (2007), mixed method research is generally classified into four categories: triangulation, embedded, explanatory and exploratory designs. These approaches have been intensively used in the field of social science as they allow a researcher to portray comprehensive dimensions of a specific subject that is being studied (Axinn and Pearce 2006).

Considering the objectives of the study, the triangulation of qualitative and quantitative data approach was chosen. In general, triangulation methodology helps the researcher to integrate different types of data and findings in order to enhance the process of analysis by making comparisons and validating data from a variety of sources. Empirically, this technique is able to enrich the research instead of using a single methodology, and to strengthen the research procedure by employing diverse tools and multiple approaches (Tashakkori and Teeddlie 1998). In addition, triangulation is relevant for cross-border study such as microfinance, as explained below.

The Islamic microfinance system, in particular, has been seen as a new model in the microfinance sector and as an anti-poverty tool. The BMT approach is a mixture of banking and finance disciplines, together with poverty alleviation, including socio-economic, cultural and spiritual empowerment of disadvantaged populations. Thus, an integrated qualitative and quantitative approach enables the study to develop a thorough picture of the faith-based microfinance system.

Second, several studies on microfinance in Indonesia (Arsyad 2006; Budastra 2003; Fitri 2006), in particular related to Islamic microfinance (Antonio 2004), demonstrate that the employment of a mixed method and triangulation has been able to capture the vibrant operations of the programs in different socio-economic and geographic settings.

Third, my longstanding experience as a micro-banker suggests that the role of a microfinance institution is not only in financial intermediation. On the ground, the interaction between the institution and its customers is also influenced by the local socio-cultural, religious and economic settings where the institution exists, and is enhanced by the relationships between personnel and clients have been established.

Finally, since the BMT institutions, observed in this study have a close association with the socio-cultural and religious values of the Islamic communities of Yogyakarta, a multi-faceted approach provides a framework in which to examine these institutions in their socio-cultural setting.

3.1.2. Case Study

Theoretically, the case study is an empirical approach to explore and understand a complex phenomenon (Gillham 2010) with the objective to explore the 'setting with a view to advancing understanding' (Cousin 2005, p. 422). The case study approach is used to enhance descriptive and explorative research, as demonstrated in this study, and other microfinance research, for examples in Bali, Indonesia (Arsyad 2006) and Papua New Guinea (Spohn 2010). In this research, the case study methodology is used for two reasons. First, to explore the dual mission of the BMT system; to provide financial services, as well as to empower the livelihood and spiritual devotion of poor Muslims. In this respect, the case study approach investigates the cultural circumstances and background of the selected BMTs, and identifies the motivation behind the establishment of the BMT and the patterns of BMTs' development. Second, the research had to accommodate incomplete data sets and other constraints. The case study approach facilitates flexibility to triangulate different variables and integrate the findings into a comprehensive analysis.

3.2. Research Sites and Timeframe

This section explains the locations and the field research schedule. However, it is necessary to discuss the dynamic process of this research as it was developed and revised to accommodate changing circumstances in the field.

The field research was begun in Jakarta with two main agendas. Firstly, to visit government agencies and conduct interviews with high-ranking officials regarding the government policies and strategies to enhance microfinance programs, more explicitly, in relation to the Islamic-oriented financiers and the BMT sector. To obtain detailed information, interviews were conducted with key officers who are directly responsible and oversee the government programs relating to the BMT sector. The second goal was to make contact with key persons from BMTC, PBMT and other relevant organisations including the Islamic Economic Society (*Masyarakat Ekonomi Syariah* or MES) and visit two leading universities, the University of Indonesia and Trisakti University Jakarta, both of which conduct Islamic banking and finance courses. In general, by employing the snowball technique that uses referral insiders to identify persons who own information and knowledge regarding microfinance and the BMT system (Biernacki and Waldorf 1981), the interviews and networking sessions are effective in broadening access to key informants and other relevant institutions.

Initially, it was intended to conduct the study in two regions: Central Java and the DIY province. However, after intensive discussions with the key informants and visits to the region, it was decided, due to logistics and access issues with some BMT respondents in Central Java, to restrict the sample of BMTs and research sites to Yogyakarta. Binns (2006) suggests that research modifications should be possible, especially when the plan is not able to be executed or when there are unpredictable impediments encountered in the field. The detailed adjustments are as follows:

1. Logistic and mobility constraints, mainly with the timeframe and budget, in reaching samples and respondents in the two provinces, which were situated from the north to south of Java. In contrast, travelling throughout the DIY province would be economically convenient and it would be easier to reach the BMT sites and key respondents as well as to conduct interviews and observations.

2. There were only a small number of BMTs involved in the BMTC network in the Central Java region which demonstrated strong interest in this study, as indicated by the feedback to the initial questionnaire distributed during the annual shareholders' meeting of PBMT in Jakarta a month before the field research.
3. As previously mentioned, Yogyakarta is one of the important regions of the BMT movement and this sector has grown rapidly since its inception in 1995. According to the database of the apex institution of the BMTs in Yogyakarta (*Pusat Koperasi Syariah* or PUSKOPSYAH), there are nearly 120 BMTs actively operating in the region, which are well organized and are members of the BMTC network.
4. There was strong support from the Chairwoman and the Executive Director of PUSKOPSYAH, who promised to approach the BMTs and key informants and encourage their participation in the research.
5. Finally, in Yogyakarta, the local government and Islamic organisations, including the Sri Sultan Hamengkubuwono X and the Muhammadiyah, have played influential roles in the BMT movement.

The research uses a longitudinal approach over a three-year timeframe (2008–2011), however, the main field study was carried out from 27 April to 4 September 2009 and it was intentionally arranged to cover two events: the general election[16] and the holy month of Ramadan.[17] The period was considered to be an important moment that would influence the dynamic of the BMT sector and the local community. During political events such as parliamentary and presidential elections, people pay more attention to the campaign issues that directly relate to their interests, and several politicians and the incumbent administration used community networks, including the BMT sector, to mobilize support among the voters. The fasting month of Ramadan, which is regarded as a blessed period by Muslims, enabled the researcher to observe the socio-religious context of the BMTs and their borrowers. In this respect, the observations were carried out to understand how the spirituality of the holy month affects the operational

[16] The general election comprises two important processes. First, people vote for the parliament (9 April 2009), and secondly, the presidential election on 8 July 2009.

[17] The holy month of Ramadan started from 22 August and ended on 4 September 2009. The period is most important for Muslims as they abstain from eating, drinking and conducting other forbidden activities between sunrise and sunset. Also during Ramadan Islamic believers are encouraged to worship, perform good deeds as much as they can, especially donate to charities. At the end of Ramadan, there is the *Eid al-Fitr* celebration, during which people visit their home-town, dress up with trendy fashions and the host families provide a variety of traditional food based on meat and chicken.

performance of BMTs, its client members and the relationship of the faith-based microfinance in the local communities.

The second period of field research was conducted in June to July 2010. The objective of site visits is to collect longitudinal data and information regarding the units of analysis, the selected BMTs. The final visit was in May to June 2011. The research at this time was mainly to collect data relating to the impact of the volcanic eruption of Mt Merapi, in the Sleman district, where some of the BMTs in the sample operated. This field work coincided with the annual general meetings (AGMs) of many of the BMTs, when their financial reports were approved by the BMT members.

3.3. Sampling Design

The sampling methodology used in this study is the purposive or non-probability sampling technique. Czaja and Blair (2005) note that the purposive technique enables the researcher to capture distinctive attributes and to observe central issues related to the study object – the BMTs in the Yogyakarta region. As the unit of analysis is drawn from the provincial level, these samples represent diverse districts, sub-districts, villages, rural and urban areas, encompassing a heterogeneous spectrum of socio, economic, cultural and religious circumstances in which the BMTs operate.

Technically, the samples are stratified into three divisions based on the criteria outlined below. The criteria are set up in order to maintain the homogeneous characteristic of variables that are being observed (Czaja and Blair 2005). In general, the selection of unit analysis simultaneously interlinks several criteria and involves two stages as follows:

The first stage involved drawing the samples at the sector level from the BMTs in the network of PUSKOPSYAH, which are accredited as Islamic cooperatives (*Koperasi Jasa Keuangan Syariah* or KJKS) by the MENEGKOP-UKM, for national licenses, the provincial office of cooperatives (*Dinas Koperasi Propinsi*) for the regional licenses, and the regency authority (*Dinas Koperasi Kabupaten/Kota*) for the local license. These samples adequately represent the BMT sector in Yogyakarta with respect to their general platforms, features and modus operandi as Islamic microfinance institutions. In addition, the samples enable the identification of the unique characteristics of the BMTs in the sample populations, which helped in the selection of BMTs for more detailed study. The second stage was to draw the cluster sample from the sector sample in order to examine the performance and sustainability of BMTs. The selection of samples was based upon the following criteria:

1. The BMTs should be well established in the communities[18] and have been operating for at least three years at the time the research commenced. As the initial financial data collection was conducted in 2009, the selected BMTs were established in 2006 or before. This benchmark was used to ensure that the unit of analysis were well-established in the community and their life cycle would be in a growth phase.
4. The selected BMTs should conduct AGMs at least three times, consecutively, and the AGM reports must be accessible to the members and the public. This criterion ensures that the unit of analysis is periodically monitored by an external agency and that good governance and internal control procedures are implemented within the institutions.
5. The unit of analysis should have submitted financial reports in the three consecutive years (2008–10), and the management and employees are available for interview and observation sessions. The BMTs that could not fully satisfy the criteria were omitted from the study.

Table 3.1. Summary of Sampling Design and Unit of Analysis

Level of Analysis	**Unit of Analysis**	**Number of Units**
1. Sector (BMTs population in the province): To identify the general characteristics of the BMT sector and to analyse its complex operations in the local community.	BMT institutions in the PUSKOPSYAH network that are entitled to an Islamic cooperative license (KJKS).	69 BMTs in the DIY province
2. Cluster (group of selected BMTs):To assess the sustainability of representative BMT in the Special Region of Yogyakarta.	BMTs had been established more than 3 years and consecutively have conducted at least 3 annual general meetings; The financial reports should be officially published; Their operations are well-known.	28 BMTs in the DIY province

Source: Author compilation from field study 2009

18 The criterion of being well-established is that the BMTs must have been in existence for three years or more. For a comparison, a newly opened BRI-Unit office in a particular area achieves financial sustainability on average in one and half years of its operation.

3.4. Data Collection, Respondents and Ethics

Mixed method research involves both quantitative and qualitative methodologies, and the nature of data collection techniques depends on the particular study designs developed (Axinn and Pearce 2006). In this study, the data collection procedures follow the concurrent method in which both qualitative and quantitative data were collected in the same time frame from the same BMTs, but the qualitative was weighted more than quantitative data (Creswell and Clark 2007). The collected information comprises primary data from BMT institutions and informants that was gathered through an open-ended questionnaire, in-depth interviews, focus group discussions and observation. The secondary data was largely obtained from official and institutional sources. The use of diverse data collection techniques and sources would increase the reliability, credibility and validity of the obtained dataset.

3.4.1. Questionnaire

The underlying concept of the survey and questionnaire is to interrogate larger samples, in this case, to develop a general picture of the BMT sector (Axinn and Pearce 2006). Through a standardized – open-ended – questionnaire, it can capture diverse issues and general attributes of BMTs in the region. The purpose of questionnaire was to examine six important issues that influence the BMTs' development and enhance their vibrant operations within the eco-socio-religious structure of the communities:

1. *Establishment and motivation*: The aim of questions is to collect the background of the BMTs, motives, visions and objectives of its establishment, and key local and national stakeholders and Islamic organisational supporters.
2. *Institutional structure*: The inquiry includes information about the organisational structure, the board of management and supervisor, human resources recruitment, staff development and management succession.
3. *Business profile and modus operandi*: The list of questions is designed to identify the business environment surrounding the BMTs, its products and services, and its operational methodology.
4. *Operation and risk management*: The questions refer to an operational manual, transactional contracts, non-performing loans (NPL), supervisory mechanism and fraud prevention.

5. *Governance and* Sharia *compliancy*: This refers to AGM reporting, the board of management and supervisor election, the decision-making process, monitoring and controlling mechanisms, source of *Fatwa* and Sharia certification, the *Sharia* supervisory board and the mechanism of assessment.
6. *Socio-religious activities*: Questions related to the organisational structure of *Baitul Maal*, charitable fund raising and allocation, programs with a socio-religious orientation, benevolent loan management and supervision, and the impact of the socio-spiritual programs.

The questionnaire was pilot-tested twice and subsequently revised on the basis of feedback and evaluations. The final questionnaire was distributed to BMT members of PUSKOPSYAH in various circumstances, such as at meetings, training sessions and other gatherings. In addition to the questionnaire, BMTs were also requested to submit a copy of their financial contracts, brochures, leaflets and other relevant printed information.

3.4.2. Financial Statements

In this study, the BMT respondents were expected to provide financial reports that comprised a published balance sheet, profit and loss statement, NPL reports and other relevant information. To ensure the data was valid and reliable, the financial report must have been approved by the AGM and audited, if possible.

Walsh (2006) suggests that financial statements should comprise a balance sheet, which states assets and liabilities at a point of time, and a profit and loss statement, which demonstrates revenues, expenses and return generated from the institution's activities for a one-year period. The financial figures should reveal total assets, earning assets, loans outstanding, deposits and saving, borrowing, capital, operational income, income from loans, return from investments, operational costs, human resources expenses, non-operational expenditure, profit before tax, compulsory charitable donations (*Zakah*) and details of loan classifications (current loans, sub-standard loans, doubtful loans and loan loss, including classified loan reserves).

As mentioned earlier, this study was a longitudinal process, therefore the financial statements collected cover three consecutive years from 2008 to 2010. The continuous financial dataset would enable the researcher to carry out the performance and sustainability assessments, and to understand the historical trend and the nature of the BMTs' development pattern over time. In addition, the longitudinal observation was very important because, as small microfinance institutions, the BMTs' performances is quite sensitive to unexpected internal and external events, for instances fraud, natural disaster and so forth.

3.4.3. In-depth Interviews

This study used a semi-structured method to obtain primary data from key informants who are associated with the unit of analysis. Seidman (2006) and Gillham (2000) state that an interview is a typical survey tool to assist the researcher to collect qualitative information, and in many cases it allows unanticipated information to emerge in the discussion.

The interviews were conducted in a variety of circumstances in Jakarta and Yogyakarta. The interviews involved key informants who represented diverse institutions, occupations, roles and backgrounds (see Table 3.2). The first key informant to be interviewed was the Director of PBMT, as he was one of the prominent BMT activists and formerly the Chairman of BMT Center that holds essential information on the national BMT sector including BMTs in the Yogyakarta region. Other important respondents included the Chairmen of PUSKOPSYAH and BMT Association (*Asosiasi BMT Seluruh Indonesia* or ABSINDO). As the leaders of apex institutions of BMT in Yogyakarta, the informants are very familiar with individual BMTs and the nature of BMT development.

Accordingly, based on information and suggestions from the interviewees and other sources, a snowball technique was developed in order to expand the network's critical respondents for in-depth interviews. Technically, the snowball approach was very helpful to identify relevant interviewees, particularly those who could not be identified at the beginning of research (Biernacki and Waldorf 1981; Czaja and Blair 2005).

In general, the interviews were conducted in natural settings such as in the respondents' offices, which helped make the discussions quite smooth and, after the interview, the on-site observations were undertaken in order to develop a picture of the activity of employees, clients, the office situation, facilities and the business environment around the BMTs.

The interviews used a semi-structured technique, so the researcher deliberately directed the interviewees by posing open-ended questions and maintained the discussion on the right track. The interview sessions were limited to between 60 and 90 minutes, and all the discussions were taped, with the interviewees' agreement, to ensure none of the information was lost. In addition, note-taking was very important, in particular to write down interesting issues about the informants' points of view and situation of the offices, sites, houses and the surrounding areas.

3.4.4. Focus Group Discussions

The FGDs were designed to capture different opinions among the BMT practitioners and client members. FGDs were used to confirm and validate the previous discussions, opinions and comments that were obtained during the interviews, observations and feedback from the questionnaire (Bloor et al. 2001). They are also a useful tool to fill information gaps as well as to identify consensus opinions related to certain issues.

The first FGD was conducted during the holy month of Ramadan with the generous support of the Islamic Economic Study Centre of the University of Islam Indonesia (UII), Yogyakarta. The discussion involved 30 participants as the representatives of BMTs, PUSKOPSYAH and academicians. The FDG was developed through the directed discussion technique and the questions related to the following broad issues:

1. The motivations and roles of Muslim elites in supporting the BMT sector
2. Regulation, supervision and good corporate governance
3. The *Riba* issue and *Sharia* compliance practices
4. The modus operandi, financial products and services, and the operational platform
5. Socio-religious responsibility and the duty of BMTs to the community
6. The business environment, challenges and the future development of the BMT sector.

The second FGD was conducted at the BMT Beringharjo, which manages benevolent financing programs to assist poor households in several areas. Finally, three other FGDs were conducted among the client members in Yogyakarta. The FGDs were focused on client members who had participated in the *Sahabat Ikkhtiar Mandiri* program of the BMT *Beringharjo* in three villages in DIY province. The detailed information about the clients' backgrounds, financial matters and motivations, as well as confirmation about the roles of BMT in the communities, was sought through the FGDs.

3.4.5. Informants and Resource Persons

The main interview and focus group discussion respondents and key informants were chosen among the government officials, members of the National *Sharia* Council (*Dewan Syariah Nasional* or DSN), non-government agencies, BMT associations, Muslim leaders, academicians, BMT managements and staffs, members of the *Sharia* Supervisory Board (*Dewan Pengawas Syariah* or DPS) and client members. Occasionally, informal interviews were conducted with people directly or indirectly associated with the BMTs' offices. As discussed in Section 3.4.3., the selection of informants was based on snowball suggestions from the key informants in the first round of interviews. The list of respondents and informants is presented in Table 4.2.

3.4.6. Secondary Data

The secondary data was sought from different sources that comprised government laws, regulations and policies that related to the BMT sector, the *Fatwa* on Islamic banking, and published and unpublished statistics, research publications, archival records, brochures, leaflets and other relevant documentations.

The major suppliers of secondary data were:

1. The Ministry of Cooperatives, and the provincial and regency cooperative offices
2. The Ministry of Social Affairs
3. Bank Indonesia (the central bank) and its regional office
4. The Revolving Funds Administration Agency (LPDB)
5. The National *Sharia* Council (DSN MUI)
6. The provincial office of the Indonesia Statistical Bureau (BPS DIY)
7. The cooperative apex institutions (PNM-INKOPSYAH, PUSKOPSYAH)
8. Research centres and universities (University of Indonesia, Trisakti University, University Islam Indonesia, University Syarif Hidayahtulah)

Table 3.2. Key Informants and Source of Data Collection

Institutional Respondents and Key Informants	**Data and Information**	**Method**
A. Government agencies 1. Deputy minister and head department of the Ministry of Cooperative 2. Head and deputy head of Provincial Office of Cooperatives 3. Deputy minister and head of department of the Ministry of Social Affairs 4. Staff and researcher of the Central Bank (Bank Indonesia) 5. The Chairman of the National Committee for Microfinance Development (PKMI) 6. Manager the Revolving Funds Agency (LPDB-KUM) 7. Member of the National *Sharia* Council	National policies, regulation and supervision Local policies, regulation and supervision Information regarding poverty alleviation program through BMT system Policies, regulation and supervision of banking system including *Sharia* bank Roles and programs of PKMI in supporting the microfinance sector Roles of LPDB as a semi-governmental institution and management of revolving funds *Fatwa* on Islamic banking and finance transactions	Interview
B. BMT associations/support institutions 1. The Executive Director OF PINBUK 2. The Chairman of BMT association (ABSINDO) 3. The Chairman of BMT Center (BMTC) 4. The Director of PT. Permodalan BMT (PBMT) 5. The Chairman of the apex institution of the Islamic cooperative (INKOPSYAH and PUSKOPSYAH) 6. The founder of the Dompet Duafa Foundation (DD)	Information on BMT sector at the national and regional levels Roles of associations Capacity-building programs Funding support Roles of Islamic charitable organisation and supporters of BMT development Roles of apex institutions	Interview
C. Bank and financial institutions 1. Management *Sharia* Banks: Bank Muamalat Indonesia, Bank Mega Syariah, BRI *Sharia*, and BPRS HIK 2. Financial institutions (*Pegadaian*, LPDB)	Information on Islamic banking and finance market and services	Interview
D. Muslim leaders and founders of BMTs 1. Muslim leaders, founders and supporters 2. Scholars	Insights on Islamic banking, microfinance and BMT Roles of Islamic scholars and their perspective toward BMT, poverty alleviation and socio-religious issues in the communities	Interview
E. BMT institutions and clients 1. BMT managements and employees 2. The *Sharia* supervisory boards 3. Clients	Information about their roles and their points of view toward the BMT system, modus operandi, and roles in poverty alleviation and empowerment in the communities Opinions regarding BMT, their perceptions and personal experiences with BMT	Questionnaire Interview Focus group discussion Observation

Source: Author compilation from field study 2010

3.4.7. Ethical Practice

The ethical procedures of the Victoria University's Code of Ethical Research informed and guided this study. All respondents had been informed of the study objectives, probability of risk and each respondent was asked to sign the consent letter.[19] For the interviews and focus group discussions, the ethics procedures were explained and the respondents' consent was recorded. Also, the participants were informed that they were able to withdraw from the study at any time without any consequence. They were also given the address, telephone numbers and emails of the principal supervisor and the university research office, to use if they had any further questions regarding the research. The ethical issues also related to the financial performance and *Sharia* compliance of BMTs, which were very sensitive matters for the BMT management, client members and the reputation of particular BMTs. Because of this sensitivity, the study did not examine individual BMTs; instead, an assessment was made of a cluster of BMTs based on total assets, region and age of the BMTs.

3.5. Obstacles in the Field

The major impediments faced during the field work were time management, accessibility and lack of standardized reports. It was often not easy to make firm appointments with the informants. As many key informants were busy with their routine assignments, appointments often had to be rescheduled. This was often the case with senior government officers. Fortunately, the background of the researcher was an advantage to ease the constraints, hence by the end of the field work nearly all the key informants had been interviewed. Many of them were supportive of my research by providing letters of recommendation including introductions to other institutions or informants.

Several BMTs were not interested in the survey because their managements were too busy to complete the questionnaire. Other BMTs refused to participate for reasons of confidentiality. They did not want to provide financial statements or financial contracts to an external organisation even for academic research. Some institutions showed

[19] There was a cultural barrier regarding signing the consent forms, which many respondents refused to sign due to misunderstanding that a hand-written signature would bear legal consequences. After further explanation they agreed to write names, institutions and address instead. In the interview, the consent of respondents was recorded.

positive interest at the beginning but finally were omitted from the survey due to internal problems, including a case of fraud.

Another critical impediment was the financial statements, many of which were not standardized. The majority of BMTs simplified the reports to make them accessible to their members. Financial information such as the balance sheet, profit and loss statement and non-performing loan (NPL) details were not uniform. Many BMTs published the statements by using their own interpretation, although the MENEGKOP-UKM regulation No. 91/2004 requires the Islamic saving and financing cooperatives to publish a standardized financial statement. In addition, many BMTs did not want to share NPL information; instead only a small number of BMTs voluntarily submitted the records but these were not uniform. A similar problem was also encountered when the BMTs were asked to provide copies of their financial contracts and other sensitive information.

The study during the holy month of Ramadan revealed some interesting experiences. In this period the majority of Muslims as well as the BMTs were involved in spiritual activities such as communal worship, reciting Al-Quran (*Pengajian*) and evening prayers (*Shalat Taraweh*) in the mosques. During the day, particularly in the late afternoon, Muslim households were busy preparing food for breaking the fast either at home or buying from the markets and food stalls which were established during Ramadan.

In general, the Ramadan month not only affected the socio-spiritual lives of people but also generated cyclical businesses to meet the high demand for food, Muslim-style fashions and other consumptive activities. During the survey, there were many BMTs busy in mobilizing funds particularly to meet the liquidity shortage, as many client members and other depositors had withdrawn their savings for school fees and in preparation for Ramadan as well as the *Eid al Fitr* or *Lebaran* celebration at the end of the month.

Surprisingly, there was no significant influence from the general and presidential elections on the operations of the BMTs and the communities, although during the campaign period many political banners were placed in public places and presidential candidate debates were broadcasted by TV stations. My conversations with BMT managements, clients and ordinary citizens revealed that the majority of people were not provoked by politicians; instead they preferred to exercise their political rights on the election day and watch the ballot counting on TV or visit the polling booths.

3.6. Data Analysis

The main data analytical tool and strategy used in this study was the concurrent-parallel mixed data analytical technique by which both qualitative and quantitative datasets were triangulated for further analysis in order to address the main research questions (Tashakkori and Teeddlie 1998). Also, conducting a simultaneous analysis provides a thorough understanding of the BMT operations.

Data analysis involves organisation and compilation. Firstly, questionnaire results, financial reports, other important findings and documents were categorized into qualitative or quantitative data classifications respectively. Following that, qualitative analysis was carried out through data reduction, data display, and drawing conclusions and verifying the analysis (Miles and Huberman 1994). The questionnaires, interview and FGD transcriptions were classified and coded by topics, categories and particular thematic issues. Finally, the quantitative data, like the financial dataset, were tabulated into spread- sheets then analysed to assess performance and make sustainability assessments.

3.6.1. BMT Sector Analysis

The nature of performance analysis is descriptive and explorative, in order to address the core research questions 1, 2 and 3 (see Chapter 1). The purpose of the analysis is to provide a general description and to investigate the operations of the BMTs, which function in a unique socio-cultural and Islamic religious setting, as well as being interwoven with the local economy that is significantly influenced by traditional agricultural production, and microenterprise and informal sectors (see discussion in Chapter 4).

The analysis seeks to examine how the BMT mainstream emerged, the motivations and who drives the establishment of this Islamic faith-based microfinance. The assessments also investigate how BMTs embrace the religious values of Islam, what are the distinctive organisational structures, modus operandi, variety and characteristic products and services, and their strengths and weaknesses, and how BMTs work under the *Sharia* compliance principles. Finally, the analysis seeks to examine the socio-spiritual roles of BMTs by assessing the function of *Baitul Maal* and how the faith-missions have been accomplished in the framework of poverty alleviation and empowerment.

3.6.2. Performance and Sustainability Assessment

In the microfinance industry, sustainability has been regarded as one of the essential elements of a successful institution and/or program. Thus, it was critical to assess the performance of BMTs under the general microfinance evaluation framework, especially to explore how the distinctive modus operandi (non-interest-based financial instruments and transactions) influences the overall performance of the institutions. Simultaneously, the analysis is carried out to understand the underlying factors that have enhanced the growth and development patterns of the BMT sector.

As reviewed in Chapter 2, there are many methodologies and approaches that are used in examining microfinance institutions, including the BMT system. Each technique has its strengths and weaknesses depending on the objectives and perspectives being examined.

In this study, as the main characteristic of BMT system is typical cooperative organisation, hence the benchmark of performance assessment of the BMTs follows the basic principles of PEARL and the MENEGKOP-UKM regulation No. 91/2004. However, because of several constraints in data collection, the key indicator of assessment was carefully modified to correspond to the available financial dataset (balance sheet and profit and loss statements) of the samples. In addition, to examine sustainability, as suggested by the Mix-Market benchmark methodology, the financial data was adjusted retrospectively by recalculating the cost of concession borrowings and in-kind supports (the subsidy effects) that are received by BMTs:

- Subsidy Adjustment = Outstanding of concession borrowing (x) yield of Islamic bond published by the government (-) actual amount of cost of borrowing paid by the BMT
- In-kind Subsidy Adjustment = Market price that an unsubsidized BMT would pay for a good or service (-) actual price paid by BMT

Furthermore, to examine sustainability, the study measures three main financial ratios (Ledgerwood 1999): (1) profitability that is reflected by return on asset (ROA), (2) operational self-sufficiency (OSS), and (3) financial self-sufficiency (FSS).

1. Adjusted ROA = Net profit (/) Average total assets (x)%
   Based on MENEGKOP-UKM regulation No. 91/2004, a sound BMT institution should account ROA ≥1.5%
2. Operational Self-sufficiency (OSS) = Operational Income (/) Operational expenses + administrative cost + provision of loan losses (x)%
   Benchmark of sound BMT institution, OSS should > 100%; in other words, a positive OSS ratio suggests that the institution has successfully reached the initial stage of sustainability
3. Financial Self Sufficiency (FSS) = Operational Income (/) Operational expenses + administrative costs + provision of loan losses + adjusted cost of capital (x)%
   Benchmark of sound BMT institution: FSS should ≥100% so that it is able to maintain the value of equity or be fully sustainable.

3.7. Summary

A robust research methodology and process are critical elements to ensure the study achieves its objectives and satisfactorily addresses the research questions. This study uses a mixture of quantitative and qualitative methodologies, and accordingly the findings and data are triangulated into a comprehensive analysis. In addition, the use of the case study approach helps to accommodate the complexity and dynamic of BMTs, thus it could provide a thorough understanding of the phenomenon.

In general, the three consecutive field studies provide sound data and interesting findings about the BMT sector and its integration in the Muslim community and local economy. However, due to the nature and inherent characteristics of the BMTs, adjustments were made in order to accommodate the collected data and information into the analysis. The following chapters discuss the evidence from the field and other secondary resources.

CHAPTER 4
PORTRAIT OF YOGYAKARTA

The Special Region of Yogyakarta has been a fertile ground of the Islamic program of community-based microfinance since its initiation in the middle of 1995. It is similar to Bali in the presence of its locally-based microfinance institution (Arsyad 2006). The region has the distinction of being the heartland of Javanese culture and the home of progressive Islamic thought. Resilient micro and small enterprises and the informal economic structure seem to be the influential factors that relate to the dynamic of the BMT sector.

The discussions in this chapter will identify the influential factors that relate to the BMT sector and how these institutions are positioned in the socioeconomic perspective. The first section briefly explains the geographic and demographic settings, which are associated with an incidence of chronic poverty, and the unique nature of the local government structure that characterises the special region. The following discussion explores the Javanese socio-cultural attributes and spiritual beliefs and practices that influence the daily lives and interactions among people and the socioeconomic institutional arrangements in the societies, and how the Islamic microfinance mainstream is perceived.

A broad review of the local economy and financial sector are presented, particularly regarding the declining role of the agricultural sector, and the growing importance of microenterprise and the informal sector as it has been incorporated within tourism and the hospitality industry. Finally, the chapter outlines the structure of the local financial market, in which formal, semi-formal and informal financial providers, including the BMT sector, play a significant role in shaping the supply and demand for financial services in different segments in the communities. To conclude the chapter, a summary is presented.

4.1. Attributes of the Special Region

The DIY province is situated along the south coast of central Java. It occupies 3185.80 square kilometres, or 0.17 per cent of Indonesia’s total territory. Geographically it is surrounded by the Central Java province and the Indonesian (Indian) Ocean. A map of Indonesia and the DIY province is displayed in Figure 4.1.

Figure 4.1. Map of Indonesia and the Special Region of Yogyakarta

The DIY territory includes fertile land on the slopes of the active volcano, Mt Merapi, the poor and dry limestone highlands in the eastern to south-eastern end, and a rich flat zone, which is situated in the western to southern region. The fertile highland and lowland zones, especially along the Progo and Opak rivers, are predominantly used as irrigated rice fields, cash crops farms and sugarcane plantations; within this area the Borobudur and Prambanan temples can be found.

Yogyakarta was granted the status of a special region (*Daerah Istimewa*) for the distinctive and historical background that was inherited from the Kingdom of Mataram, and the loyal support that Sri Sultan Hamengkubuwono IX gave to the Republic, during the struggle for independence against the Dutch colonial government.

The region is also known as the centre of traditional Javanese culture and traditions as these have developed since the era of Hinduism–Buddhism and the emergence of Islam. Culturally and politically, the position and roles of the Sri Sultan are unique. In the eyes of the people of Yogyakarta, the Sultan is the utmost authority and the king who holds supreme power to protect the entire community (Selosoemardjan 1962). It has been a common tradition in the local communities to demonstrate their sincere honour, admiration and great loyalty to the Sultan, the royal family and the symbols of the monarchy. For his part, the Sultan shows his great concern for the wellbeing of his people.

The Special Region Law No. 3/1950 grants the Sultan the power to rule the region's domestic affairs and to maintain the kingdom's customs and traditions. The Sultan's authority is akin to that of a provincial governor. The Sri Sultan fulfils these dual roles as the sultan and the governor. The current governor is the Sri Sultan Hamongkubuwono X and the deputy governor is the Paku Alam IX, another member of the Yogyakarta royal family. Under the DIY provincial structure, there are *Bupati* and *Walikota* as heads of district and municipality administrations respectively.

four districts (*Kabupaten*) and one municipality (*Kotamadya*): Bantul in the south, Gunung Kidul in the south-east, Kulon Progo in the west and Sleman in the north, and Yogyakarta city in the centre. Each of the districts/municipalities supervise a larger number of sub-districts, villages and hamlets, but the area within each district, with the exception of Gunung Kidul, is small compared to counterparts in other provinces. With an adequate road network and public infrastructure, nearly all the region and remote hamlets are connected and accessible by public and private transportation, which allow people to be mobile and for agricultural commodities and goods to be distributed within the region.

Table 4.1. Area and Local Administration of the DIY Province

Key Indicators	Regency/Municipality					DIY Province
	Bantul	**Kulon Progo**	**Gunung Kidul**	**Sleman**	**Yogyakarta City**	
1. Area (km2)	506.85	586.27	1,485.36	574.82	32.50	3,185.80
2. Sub-district	17	12	18	17	14	78
3. Village	75	88	144	86	45	438
4. Hamlet	934	930	1,432	1,212	-	4,508

Source: BAPPEDA-DIY (2010).

Although the DIY province has the status of a special region, its districts/municipality governmental structure and administration system are regulated by the Regional Autonomy Law No. 22/1999, as revised in Law No. 32/2004, regarding regional government structure and the Law No. 25/1999 regarding the fiscal relationship between the central government and regional administrations[20]. Under Law No. 32/2004 the head of district or *Bupati* and head of municipality or *Walikota*, are elected directly by the people for a five-year term.[21]

In general, the principal objective of decentralisation was to enhance the authority of the *Bupati* or *Walikota* to manage the local administration and to allocate the budget,[22] as well as to mobilize internal sources of revenue with less intervention from the provincial and/or central governments. Thus, it provides greater opportunities for the local leadership to determine its own agenda and the socio-welfare programs that are suitable to the local socio-economic conditions and to enhance the livelihood and prosperity of the majority of the inhabitants. In other words, democratisation and decentralisation empowers more people to participate in formulating public policies, and encourages local development initiatives. Since its inception, however, the implementation of the decentralisation system has not successfully met public expectations. There is some evidence to suggest that the provision of greater authority

[20] These laws were revised in 2004

[21] At the district/municipality level, there is also a local parliamentary council (DPRD) elected in the national general election as stated in the Law No 10/2008 regarding the general election and parliamentary membership along with provincial and national parliaments (DPR, DPD and DPRD). The local parliament functions are mainly to legislate, make regulations and scrutinise the budget. In addition, each of the district/municipality governments supervises sub-districts (*Kecamatan*), and villages (*Desa* and *Kelurahan*), and hamlets (*Dusun*).

[22] The central government provides a block grant that consists of a general allocation budget and special allocation funds to support regency/municipality administration. In addition, the local central government shares 15 per cent of oil and 30 per cent of gas revenues, 80 per cent of forestry, mining and fishery incomes to each regency/municipality, which relates to these strategic natural resources.

to the *Bupati* or *Walikota* tends to create political tensions and disharmony between the district/municipality administrations and the provincial and national governments, as well as with neighbouring district governments (Brodjonegoro and Asanuma 2000; Sukma 2003).

Interestingly, in Yogyakarta, conflicts among the elite rarely occur and the nature of political relationships between the provincial and district administrations is relatively harmonious, although there are deficiencies in coordination and policy synchronisation among the government agencies. It is hard to deny that the Sultan has successfully used his authority and traditional power to enhance the socio-political harmony in the region. It seems that the dual leadership of the Sultan, both as the legitimate governor and as the symbolic king of the Yogyakarta monarchy, is an exceptional political asset for this region to achieve its development objectives. More recently, however, the central government has considered an amendment to the Special Region Law by introducing democratic election rather than maintaining the political right of Sri Sultan to be the appointed governor. If this were to happen, the status of the DIY would become like that of an ordinary province.

4.2. Socio-Demographic Background

According to the DIY government report, the number of inhabitants in the DIY province in 2009 was over 3.4 million. With the population concentrated mainly in urban areas that made up Yogyakarta city (11,941 inhabitants per km^2) and the surrounding suburbs, it is the second most overcrowded region after the capital city, Jakarta. Over the decades, the population in this province has steadily increased approximately 1 per cent annually, but it was below the national trend (BAPPEDA-DIY 2010). This demographic figure was related to the natural birth rate and inward migration (mainly of students) from other regions, as Yogyakarta is a centre of higher education. Among the districts, Sleman and Bantul are densely populated areas, as their territories merge with Yogyakarta city. There is also intensive wet-rice agriculture and cash crops cultivations in those districts. In contrast, reflecting the marginal geo-ecological conditions, the population density in Gunung Kidul district is lower (454 inhabitants per km^2). Large areas of the Gunung Kidul district are not inhabited and are unsuitable for any form of economic activities.

Concerning the age of the population, almost three-quarters of the residents were between 15 and 64 years of age, which suggests a favourable dependency ratio between unproductive inhabitants (below 14 years old and above 65 years old) and productive residents. The human resource indicators such as the literacy rate suggest that nearly 90 per cent of the population were literate. The school enrolment index was 94.2 per cent for children in between 7 and 12 years of age, 72.3 per cent for teenagers 13–15 years old and 55.8 per cent for teenagers in the 16–18 year age group. The length of school participation was 9.7 years, or equivalent to the secondary education level. In 2009, the overall Human Development Index (HDI)[23] scored 75.2, meaning that the DIY province was classified into the medium–upper category behind the Jakarta, Riau and North Sulawesi provinces. Within the region, Yogyakarta city achieved the highest index (79.2), which was substantially above the district of Gunung Kidul (70.1).

The economy can be divided into formal and informal sectors. Occupations in the formal sector include those mainly in the government agencies, private institutions and business ventures; these professions employ residents who have graduated from higher education. The informal sector embraces peasant farmers, the self-employed, market traders, artisans, craftsmen, waged labour, micro and small entrepreneurs, and various low-paid and occasional workers.

Broadly speaking, poverty remains a critical issue in the region, as poverty was relatively high at over half a million, or 16.7 per cent of the population, as of December 2009, with most of the poor inhabitants residing in rural areas (53.2 per cent). In the last five years, the incidence of poverty has declined, with the exception of 2006, when the poverty rate increased to 19.1 per cent as result of the earthquake in May 2006, but it was above the national figure and among the provinces in Java, it was marginally better than Central Java and East Java.

Poverty is most prevalent in rural areas lacking natural resources. Nearly one-third of Gunung Kidul’s population was poor, with an economy based on wet-rice agriculture, cash crop farming and low-value staple commodities such as cassava, maize and several leguminous varieties (Dunham 2009). A similar situation occurs in Kulon Progo,

[23] The Human Development Index (HDI) is developed by the United Nations Development Programme (UNDP), it is a composite index of socio-economic indicators that comprises life expectancy, literacy rate, school enrolment and standard of living.

although this district is in a lowland agricultural zone. The incidence of poverty is related to the presence of subsistence agriculture, and limited opportunities to conduct off-farm microenterprises and to enter non-agrarian employment.

Chronic poverty is a lack of land ownership in the countryside and access to formal employment. As population growth has increased, many villagers own less than 0.1 hectare of land (Dunham 2009), and although the farmers have adopted modern agricultural technology,[24] crop production and on-farm income as a primary income is not sufficient for daily subsistence and other basic needs. For the landless inhabitants, sharecropping or leasing land from a landlord is an alternative means of producing staple food and generating some income. As the peasants lack capital and have no access to affordable credit for providing agricultural inputs, they depend on informal sources such as moneylenders or obtaining credit in kind from the local suppliers (Soegiarto 1993). In turn, the landless farmers fall into a debt trap and become poorer. The destitute also engage in casual employment (less than 35 working hours per week) through agricultural, informal and low-wage work, but these under-paid jobs do not generate sufficient income to sustain a normal standard of living.[25]

Limited employment opportunities have affected outgoing migration[26] through voluntary transmigration program to provinces outside the Java islands and as migrant workers overseas. In addition, the marginal urban population is involved in entrepreneurial microenterprises as petty traders and other forms of self-employment. The result is that the geographical settings significantly influence the socio-welfare of the inhabitants, particularly as they relate to the higher incidence of poverty. Also, the

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24 In the early 1970s, the government introduced the BIMAS program and *Panca Usaha Tani* (green revolution) by adopting modern farming practices, a high-yield rice variety, an organic fertilizer, chemical pesticides and an irrigation system. The efforts successfully increased rice production, and Indonesia reached rice self-sufficiency in 1984. The BIMAS program also had an impact on poverty that significantly reduced the number of destitute households. Furthermore, the government transformed the subsidised loan (a part of the BIMAS program) into commercial microfinance loans (*Kupedes*) that allowed households to establish microenterprises, earned additional off-farm incomes and stabilized food purchasing power (Robinson 2002).

25 The Sakernas survey recorded that 24.5 per cent of the workforce, predominantly women engaged in the casual labor market. And 20.5 per cent were unpaid workers, with 'wages' being in the form of food or rice instead (BAPPEDA-DIY 2010).

26 The total population that has joined the transmigration program was 274,926 or 76,495 families. The earlier transmigration programs during the New Order regime were massive, and people were forced by the government to move to other regions, which in turn created conflicts and social problems. Today, the transmigration program is a more voluntary initiative of the residents, but the government still provides an initial allowance to provide support during the settlement period in the new regions. The average number of migrant workers from the DIY region was above 1060; the majority worked in Malaysia as domestic helpers and as construction project laborers (BAPPEDA-DIY 2010).

socio-demography profile of the DIY province also corresponds with the socio-economic structures and typical livelihood of residents in Yogyakarta, in which a large segment of the population engages in subsistence agriculture and informal activities. These sectors have shaped the pattern of economic development.

4.3. Socio-Culture, Religious Beliefs and Practices

Ethnically, the population of DIY province is mostly Javanese, a mixture of natives of Yogyakarta, and other Javanese from the Central and East Java regions.[27] There are also minority populations of other Indonesians of Arab, Chinese and non-Javanese background, many of whom live in Yogyakarta as students. Among the values prized in Yogyakarta society are calmness and gentleness (Smithies 1986), peaceful manners (*Tentrem*) and social harmony (*Rukun*).[28] These ideals are of primary importance in every aspect of individual life (Guinness 1986). The Javanese avoid open conflict and are tolerant and respectful to each other. *Ewuh Pakewuh*, or a differential attitude towards persons of higher status in the family and social order, is considered an important element in maintaining social harmony. The expression of feelings should be done in a proper way, with the appropriate choice of language and gesture.[29] Social harmony is a vitally important ideal in their social lives and should be present in the nuclear family as well as in society as a whole.

In daily life, the Javanese express values of harmony in relationships among the members of family such as 'seniority, mutual assistance and reciprocal obligation' (Guinness 1986, p. 139) and 'to place himself in another person's situation (*Tepa Salira*) and *mangan ora mangan nek ngumpul* that people enjoy being close together with relatives more than they enjoy the food' (Koentjaraningrat 1985, p. 475).

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27 The Javanese have a rich and diverse culture, language, accent, script, art, music, customs and tradition, foods, dress and clothes, and household affairs. This diversity has been influenced by geography and history (Kuntjoroningrat 1985).

28 A detailed discourse regarding the multiple meanings of harmony (*Rukun*) in the perspective of the Javanese culture can be found inGuinness (1986). *Rukun* is an essential element of the Javanese community, and Indonesian in general, hence the term of *Rukun* literacy translated into the community administration structure such as *Rukun Tetangga* (RT) and *Rukun Warga* (RW).

29 The Javanese language includes different expressions and styles of speech that distinguish social status in three levels of language: informal, polite and extremely polite (Geertz 1960).

The ideal of social harmony is equally important in the wider society. Maintaining harmony among the neighbours and the broader community is the utmost socio-cultural ideal of the Javanese. Selosoemardjan (1962, p. 328) suggests it is 'a strong society norm' that wealthy Javanese should show a sense of philanthropy toward their less-fortunate relatives and fellows. Similarly, Koentjoroningrat states that there is an 'obligation to maintain good relations with one's close neighbours, pay attention to their needs and share with them as much as possible' and '[T]rust in' is the essential guidance as to how the Javanese collectively maintain their relationship (Koentjaraningrat 1985, p. 458–9).

In this respect, Guinness (1986) observes that the value of social harmony supports a sense of solidarity, cooperation and social bonding as well as egalitarianism. For example, among urban dwellers in Yogyakarta there is evidence that social harmony is a paramount value in bridging the differences:

> Although many parents to whom I spoke were sad that their children had chosen to join another religion, all were proud that the different faiths were never a cause of conflict within the family. In general they admitted that religion was never or rarely discussed among family members, but were happy in the knowledge that their children's faith, like theirs, was sincere (Guinness 1986, p. 135).

These socio-cultural values do not eliminate individual interests and differences, but these should be expressed in a proper manner, particularly when communicating with senior members of the family and people of higher rank in the community. These values of harmony and respect are expressed in ceremonies like the *Slametan* (Geertz 1960; Jay 1969) and Islamic rituals such as *Pengajian* (Beatty 1999; Kim 1996), which reflect the communal spirit of togetherness and social status (Guinness 1986). The community mutual help organisation, *Gotong Royong*, and collective organisations or *Paguyuban* are long-established and practised in everyday life as well as in times of rehabilitation after natural disasters (Koentjaraningrat 1985).

In general, the Javanese culture and traditions are supportive of the concept of cooperatives based on community and common interest, cooperation and social harmony. In particular in Yogyakarta, people are familiar with different kinds of community-based organisations for shared economic and socio-religious purposes. The community organisations tend not to distinguish between members on the basis of social status, ethnicity or religion. Consequently, the social and cultural backgrounds of the communities in Yogyakarta are favourable ground for cooperative microfinance including BMTs, which operate along similar lines as other types of microfinance programs.

In the region, all formal religions[30] and local Javanese beliefs exist in the society. However, statistically, Islam is the majority religion, with about 90 per cent of Yogyakarta's population identifying themselves as Muslim. For an outsider, it is quite difficult to differentiate between ritual practices, cultural traditions, cults and pre-Islamic customs that have become intermingled with Muslim religious beliefs and practices in contemporary Yogyakarta society. Several studies and Javanese literature suggest that in the early period of Islamisation in Java, the teachings of monotheism religion were carried out through socio-cultural approaches and acculturation processes among the local and Muslim traders from India and the Middle East (Beatty 1999; Headley 2004; Woodward 1989).

Islam first spread in Java in the era of Hindu–Buddhism kingdom and was embraced by people because the Islamic teachings and values were compatible with Javanese ancestral cults and mystical beliefs. The Javanese accept the practice of Sufism that is regarded as the source of supernatural power. Occultism and the mythology of the Sultan and the monarch's symbols (*Pusaka)* is believed by many Javanese to have magical powers to protect against pernicious calamities and to bring a peaceful atmosphere to the communities (Selosoemardjan 1962). In addition, the socio-religious ritual of '*Slametan*' (Geertz 1960; Jay 1969) evolved from the ancestral animism and Hindu–Buddhism and has been adopted by Javanese Muslims as a spiritual devotion although this ritual is not consistent with the Five Pillars of Islam.

Geertz identifies three typologies of the Javanese Muslims and how they embrace and practise the Islamic tenets in their spiritual devotions: *Santri*, *Priyayi* and *Abangan*. The *Santri* are pious believers often associated with Islamic boarding schools (*Pesantren*), Arab traders and middle class Muslims. *Priyayi* are Muslims who are associated with

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[30] The government acknowledges six religions: Islam, Protestantism, Catholicism, Hinduism, Buddhism and Khonghucu.

the Sultans' courts including government officials. The *Abangan* include many villagers and lower class inhabitants of urban societies (Geertz 1960). However, Geertz's definition has been the subject of much debate among Javanese anthropologists, particularly in defining the *Priyayi* in the Islamic context (Beatty 1999; Kim 1996; Woodward 1989).

Another study classifies Islamic traditions in Yogyakarta into two main groups: traditionalist and modernist (Kim 1996). The former belongs to the Javanese Islam tradition that retains the syncretic attributes and ancestral cults of Javanese beliefs. The latter is a revivalist form of Islam that interprets and practises the teachings in accordance to the Holy Qur'an and the *Sunnah* of the Prophet Muhammad. The renaissance of modernist Islam in the region was in 1912 when an Islamic scholar, K.H.Ahmad Dahlan, established Muhammadiyah in Yogyakarta city (Nakamura 1983). Moreover, Alfian (1989) states that the organisation is not formally affiliated with a political party; rather it has socio-religious goals to promote Islamic values through a modern educational system and community-based missionaries (*Dakwah*), including the provision of health services. As the organisation introduces an alternative approach to practising Islam, Muhammadiyah attracts many Muslims from diverse backgrounds, especially intellectuals and middle-class entrepreneurs, hence Muhammadiyah is very supportive toward economic activities, although it is not formally directly involved in business ventures.[31] In this respect, the modernists belief that religious teachings is not only related to ritual devotion but provides guidance in many aspects of life.

In summary, the modernist tradition is more supportive of economic activities whereas the traditionalists focus on ritual. The strength of the modernist tradition in Yogyakarta provides a supportive environment for BMTs as faith-based microfinance community-based institutions.

31 In the mid 1990s, some leaders of Muhammadiyah established a conventional commercial bank outside the structure of Muhammadiyah. The bank ultimately failed. Influential leaders and scholars of the Muhammadiyah were also involved in the establishment of Bank Muamalat Indonesia (BMI), the first Islamic bank and the BMTs (discussed in chapters 6, 7 and 8).

4.4. Economic Structure

In the 1990s, the average economic growth of Yogyakarta was consistently above 7 per cent, however, after the crisis of 1997–98 it has never achieved such a high rate of development. In the last five years, the gross domestic regional product (GDRP) (at a constant price) only reached the peak level of 5.1 per cent. Following that, growth gradually decreased to 4.7 per cent in 2004 as a spiral effect of a high petrol price policy, and it further declined to the lowest point of 3.6 per cent in 2006 in the aftermath of the earthquake. The disaster destroyed much vital economic infrastructure, and impacted on business and commerce activities such as the financial, construction, real estate, trade and service sectors. Recently, the economic trend has revealed a positive sign as the annual growth of GDRP in 2009 was over 5.7 per cent (BAPPEDA-DIY 2010), which, however, was below the national average performance and not sufficient to create more employment opportunities, to alleviate poverty and to support sustainable development.

Broadly, the core of the economic structure of the region is agricultural, and microenterprise and SMEs (small and medium enterprise sector). But in total, the financial and capital-based industries such as financial, rental and business service, and transport and communication businesses demonstrated the highest growth – on average 6 per cent annually. In particular, the progressive development of the financial sector (consumer loans of commercial banks and multi-finance institutions) reflected the increasing demand for cars and motor bikes, housing and household goods.

Similar evidence can also be seen in the communication sector, which was driven by flourishing mobile phone usage. In contrast, the agricultural sector was stagnant, growing less than 1 per cent. By share, however, the largest contributors were government-oriented services, and trade, hotels and restaurants, which constitute more than one-fifth of the GDRP. Since the financial crisis a decade ago, it has been common for the government budget to play a strong role in supporting the local economy through the public service's demand for goods and services required for routine administration as well as specific projects.

The trade, hotels and restaurant sector has become more important in the economic structure (see discussion in 4.4.2. The Emerging Tourism and Hospitality Sector),

supplanting agriculture. The second layer sources of economic growth were construction, transportation and communication, and finance, rental and business services, which contributed up to one-third of the regional economic output. The least important sectors consisted of electricity, gas and water supply, and mining and quarrying.

In term of GDRP per capita, although Yogyakarta has experienced growth, it still lags behind other provinces in Java. Among the local administrations there has been uneven GDRP performance: Sleman and Yogyakarta city demonstrated the highest growth. The better performance of these administrations was gained from their economic advantages as the most developed regions, and as the centre of businesses and the tourist economy. Interestingly, slow growth of GDRP was evident in Bantul, which has not fully recovered from the impacts of the 2006 earthquake.

It is also important to note that the structure of the economy in Yogyakarta city and the surrounding districts has gradually shifted to non-agricultural sectors, with greater exposure in trade and tourism, with a corresponding change in the labour market from the agrarian sector into non-farm micro-entrepreneurship. The emergence of informal economic activities has supported the local financial market and the growing demand for microfinance products. This economic transformation helps explain why BMTs have rapidly expanded their operations in the regions, along with conventional microfinance.

4.4.1. Decline of the Agricultural Economy

Agriculture is fundamental to the livelihood of the people in Yogyakarta. Benefited from its outstanding geographical position in the fertile zone of southern Java and a stable water supply all year around, this region has been recognised as a leading producer of food (rice and staple commodities) for many decades (Kim 1996). As stated earlier, the Bantul district is relatively poor and infertile. The provision of a flat ideal landscape and fertile soil, meant that large areas were suitable for cash-crop plantations, which were first developed under the Dutch colonial government (Geertz 1963a) then taken over by state-owned companies after independence.

The peak period of development in agriculture in the region was in the 1970s and 1980s when the government launched the BIMAS program along with the *Panca Usaha Tani* methodology that introduced high-yield varieties of rice, the use of fertilisers, pesticides and new postharvest technologies. During the same period, many dams and irrigation systems were built to supply adequate water for the wet-rice fields. Ultimately, Indonesia successfully achieved self-sufficiency in rice production, and the government received international recognition for these efforts. Gradually, the strategic position of agriculture in the regional economy of the Yogyakarta has been replaced by other sectors that have become more significant in generating employment opportunities.

The decline of the agricultural economy was caused by three interwoven factors. First, large parcels of fertile rice farm (*Sawah*) have been taken over for hotels as the tourism sector grew very aggressively. In addition, more agricultural land has been utilised for infrastructure and business purposes, including residential complexes to accommodate the growing population. From the early 1990s in Yogyakarta there has been a process of changing land use from *Sawah* to non-agricultural purposes. The average decline of *Sawah* has been nearly 0.39 per cent every year, and it is steadily increasing in order to accommodate the vast demand for housing and land acquisition for industry. Typically, ownership of land has circulated within village communities (Kim 1996), however recently *Sawah* have been sold to outsiders. This transfer of land ownership has meant that many peasant households have become landless and slipped into chronic poverty (Manning, 1988). As a result, the change in land use has meant that villagers have needed to seek employment in non-agricultural sectors.

Second, as more people have had access to higher education, and with the emerging growth of industrialization, as well as the improvement of economic conditions, more young residents have moved to urban areas to occupy semi-skilled and/or skilled occupations, or to engage in self-employment including setting up business ventures. The outgoing migrations, both temporary and permanent, led to labour shortages in most villages, although the gap is filled by women workers and mechanisation. The on-farm labour market remains a crucial issue as compared to the previous decade, with a decline in the agricultural labour force of nearly 9.3 per cent (BAPPEDA-DIY 2010).

Finally, after the BIMAS program and following the reforms of the banking system since 1983, the agricultural sector, in particular rice and staple food farming, has received less financial support from commercial banks. This is a consequence of the government's policy on bank liberalisation and the reduction of subsidised credit for rice farmers provided during the Green Revolution. The implication for the development of microfinance is that landless farmers have resorted to seeking a livelihood in non-agricultural sectors of the economy, especially running microenterprises and other self-employment professions, and have become potential customers for microfinance programs.

4.4.2. The Emerging Tourism and Hospitality Sector

The rich culture traditions and heritage of ancient Javanese kingdoms, the presence of Borobudur, a Buddhist temple, and several Hindu temples, as well as the Yogyakarta Sultanate, a successor of the Islamic kingdom of Mataram, make the region around Yogyakarta a major tourist attraction. Wayang puppet shadow plays, Islamic ritual ceremonies (*Sekaten*), waxed painting (*Batik*) and traditional craftsmanship make Yogyakarta Indonesia's foremost cultural tourism destination after Bali.

The development of the tourism sector in Yogyakarta was adversely affected by the earthquake in 2006, however, with effective government support tourism facilities were restored and tourism has been intensively promoted. In 2009, the total number of visitors to the province was 1.3 million, with the majority being domestic tourists (90 per cent). The positive impact of the rising numbers of tourists was to increase the occupancy rate of hotels and accommodation, and increasing the average length of stay both for foreign guests and domestic travellers. The central tourist destinations and related facilities are surrounding Yogyakarta city, Sleman and Bantul (BAPPEDA-DIY 2010).

When considering the impact of culture in the economy, the tourism sector has been gaining attention because it promotes Javanese culture and traditions and generates revenue for the government through direct and indirect taxes, boosts the volume of trade and commerce, and also creates multiple benefits to communities such as employment, income-generating activities, and business opportunities for the local microenterprises. Additionally, it attracts investments and further infrastructure developments such as airports, roads, hotels, restaurants and commercial centres. In general, the development of the tourism sector has led the regional economic development and is likely to become more important than the traditional agricultural sector in the future.

Yogyakarta is known as a student city (*Kota Pelajar*) and a centre of higher education in Indonesia. The presence of the state University of Gajah Mada, leading Islamic tertiary institutions such as the Indonesia Islamic University and other private universities, attract a large number of students from across Indonesia to pursue higher education degrees, and interestingly, many of the graduates remain in the region. In the process, the influx of those students affects the population figures and population density of the city and suburban areas where the universities and colleges are situated (Subanu and Leksono 2008). These students also influence the local social and cultural diversity of the society through dynamic cultural exchanges, and natural acculturation and assimilation processes. In addition, from the economic point of view, the higher educational sector has created additional demand for accommodation, food, household goods and other related needs, and these services are mostly provided by self-employed suppliers and microenterprises. Worth noting that several universities in Yogyakarta for examples Indonesia Islamic university (UII) and Islamic University of Sunan Kalijaga play an important role in the BMT movement since many of BMT leaders and employees graduated from the universities. Also from the academic standpoint, the BMT system has been an emerging subject of research for university students.

In summary, the shift of the economic orientation from subsistence agriculture towards cultural tourism and the hospitality sectors has changed the economic structure of the province. This transition also influences the economic activities in the informal sector as community-based productive activities become more integrated into the economic mainstream. The positive implication of the recent changes in the economy from agriculture to a service economy has been the growth of the microenterprise and informal sectors in tourism centres and surrounding villages, with a flow-on demand for microfinance services and a supportive environment for the BMTs to grow.

4.4.3. Dominance of the Informal and Microenterprise Sectors

In the period following the 1997–78 financial crisis, the informal and microenterprise sector has grown rapidly and become a backbone of the Indonesia economy. Microenterprises and SMEs have played an important role in accelerating economic growth and job creation in the informal sector. Java, including Yogyakarta, is the centre of microenterprise (Tambunan 2005). In 2009, the number of small and microenterprises was recorded at over 33 thousand units (BAPPEDA-DIY 2010). In particular, the microenterprise sector holds a strategic position because of its characteristics embedded in the socio-culture of the society and how it influences the structure of the grassroots economy. In this context microenterprises assist in the alleviation of poverty for destitute and agriculture-based households.

As explained earlier, engagement in off-farm income generation activities is a rational choice for poor peasants and the landless, both to survive and to supplement household earnings between harvest seasons. For better-off households, micro-businesses are another strategy to diversify income sources from agriculture. Similarly, in the urban areas, it functions to absorb the surplus labour due to urbanisation and the oversupply of the semi- and low-skilled labour force, which has not able to participate in the formal sector. The informal and microenterprise sector is important in the division of labour which allows women to participate in economic production outside the household and earn income to support their families.

Much of the informal sector in Yogyakarta is in handicraft industries (Tambunan 2005) which employ intensive low-wage labour. This is a sector characterised by low productivity because of lack of technology and obsolete production methods. The operations of businesses are solely controlled by family members who have only basic education and limited knowledge in business management. The other features of these informal enterprises are weak networking skills and marketing strategies, since their business sales and development rely upon the role of middlemen or intermediate traders, as well as limited access to financing from the commercial banks.

The informal and microenterprise sector varies in terms of legal status, size of the company, its products, activities and business orientations. As explained in Chapter 1, the government has defined microenterprises as having net assets of up to IDR 50 million and sales of up to IDR 300 million. Microbusinesses can be classified by product and economic activity into agribusiness (many kinds of traditional foods, snacks), trading (groceries, household goods suppliers, garments), services (restaurants, transportation and others), manufacturing and handicrafts (metal and iron casting, wood carvings, furniture, terracotta goods, leather craft, silver work, batik and garments). Diverse microenterprises are part of the tourism sector for both domestic and overseas customers (Tambunan 2005).

As famous as Bali (Arsyad 2006), the Yogyakarta region is also a centre of handicraft production. The handicraft sector is cottage-based and the size of the businesses range from micro to small enterprises. The Yogyakarta handcrafts, including *Batik*, are widely known and distributed in both the domestic and international markets. Traditionally, batik is associated with formal and informal uniforms, clothes, sarongs and other dress accessories, but recently it has been creatively developed for sale as souvenirs and contemporary art forms. The *Batik* supply chain is complex and involves self-employed artisans, middlemen (collectors and traders), wholesalers, boutiques, department stores, and the textile and garment industry as well. This craftsmanship is not only a distinctive cultural art but it generates economic value broadly in the society. Beside *Batik*, several other outstanding handicrafts such as silver work, leather craft and wood carving, and particular traditional foods, such as the *Bakpia* snack, are among the microenterprises and household products that generate economic benefit to the communities in the province.

Pasar Tradisional are an important element of the informal sector. Commonly, the market is a place where the sellers and buyers meet, and goods and commodities are traded outside formal retail buildings. Markets are complex social settings and are representative of informality, traditional cultures and symbols of poverty (Alexander 1987). In Yogyakarta, markets are situated across the city and smaller townships and in villages.

The number of markets and their size and layout follow the structure and size of cities and townships. There are usually more and bigger markets in the cities, and fewer and smaller markets in townships. The markets trade in a variety of goods and commodities. In the early morning the trading activities are agricultural commodities; during the day, household goods, grocery and garments, and in the evening, the markets are occupied by food stalls and street cafes. In addition, several markets sell only specific commodities, such as cattle or batik.

Market places are a location of the informal and microenterprise sector. The sellers and traders in the markets are micro entrepreneurs linked to the supply and value chains and business networks. As trading centres, markets are also the focus for commercial banks, microfinance providers and informal moneylenders. From another angle, the market place is a miniature of society where the social, cultural and economic exchanges take place (Geertz 1963b).

The earthquake of 2006 destroyed many microenterprises, home-based industries and market places, especially in the Bantul district. In addition, the disaster caused psychological trauma to the traders who, temporarily, had to conduct their trading activities outside the market places.

The informal and microenterprise sector has played a vibrant role in the communities and it has been an effective tool in the socio-economic development of the region and in the alleviation of poverty. It is clear that the unique characteristics of the Yogyakarta economy and the dominance of the interwoven nature of microenterprise and household income-generating activities constitute a favourable environment for the microfinance sector, including the BMTs.

4.4.4. Employment and Labour Market Figures

The employment statistics for 2008 revealed that the total number of people in the labour force was approximately 2 million,[32] and those were largely employed in various economic sectors. Unemployment stood at 4.4 per cent, being mainly in urban areas and including large numbers of youth and tertiary-graduated (BAPPEDA-DIY 2010).

Compared with the figures for 2007, the annual employment growth was nearly 2 per cent, and it was mainly due to new entrants who have just graduated and/or dropped out of formal education. In urban areas, the growth of the labour force was three times higher than in rural areas, which indicates migration to the city and suburban areas where economic activities are concentrated and more job opportunities are available. In the last five years, employment opportunities have been showing a positive trend indicating that more people are being employed and unemployment was slightly lower, particularly after the earthquake. It seems the disaster recovery programs have absorbed substantial labour in the short-term.

Furthermore, by comparing the employment rate and the economic growth (employment elasticity), the Statistical Bureau of DIY suggests that each percentage increase in economic growth created over 5000 jobs, thus, the average economic growth (4.5 per cent annually) absorbs nearly 26,000 workers annually (BAPPEDA-DIY 2008).

[32] The total productive population (between the ages of 15 and 64 years of age) who worked, were jobless and do not work was 2.8 million. That consisted of a labour force of 2 million and the non-labour force of 800 thousand, hence the participation rate (a ratio of the labour force and the total number of productive residents) was 71.4 per cent (BAPPEDA DIY 2008).

By sector, mining activities accounted for the highest (positive) employment elasticity, as this sector naturally is labour intensive, especially during the physical reconstruction and following the eruption of Mt Merapi. The financial, real estate and service sectors also employed more workers, particularly to support the vast expansion of banking and financial institutions in the region.

In contrast, the employment elasticity of the agricultural sector was negative, which was reflected in a declining labour force engaged in farming activities, however one-third of the labour force remains in agriculture-oriented employment. These sectors are followed by trade and tourism, service and manufacturing. The three main sectors employed over half of the labour force and these sectors have shown a progressive development in the recent years.

Overall, the figures for informal employment are consistent with the socio-demographic profile, the nature of the means of livelihood of the majority of the population, and the economic structure related to agriculture, informal and microenterprise sectors. In addition, overseas employment has become an important factor in reducing the number of unemployed people. The flow of remittances has steadily increased the support to the migrant workers' household incomes and to alleviate the families from chronic poverty, including benefiting the microfinance sector.

4.5. Local Financial Intermediation

Financial intermediary arrangements in Yogyakarta consist of formal, semiformal and informal institutions. The primary products are loans, deposits and savings, remittances, payment services, insurance and other financial services. Their modus operandi include the generic conventional banking model, and the Islamic (*Sharia*) system that was recently introduced to expand the regional financial market.

In 2009, based on the Bank Indonesia's statistical report, there are about 95 commercial banks and BPR, with a network of 494 outlets in the region. However, the location of these bank branches is mostly in the big cities, the semi-urban areas and major market places in smaller townships. The BRI, though, has a network of microbanking offices in the sub-districts and major villages. Almost half of the banking outlets were associated with commercial banks, both private-owned bank and government-owned banks; one-third of the outlets belongs to the BPR and the remaining outlets were units of the regional government-owned bank (Bank DIY).

In 2009, a total of IDR 19.6 trillion public funds were collected, which was an increase of 16.9 per cent compared to the previous year. These public fund liabilities comprised of about half as passbook savings, one-third term deposits and a smaller amount of current accounts. Of the funds, approximately IDR 11.7 trillion were allocated to commercial loans; in other words it rose by 11.9 per cent, slightly less than the funds growth. It was evident that the loan-deposit ratio of commercial banks in Yogyakarta was lower than the average of the banking sector and it also amounted to less than one per cent of the whole banks' loans (BI 2010a).

The government-owned banks have a dominant position with a substantial market share. The second category of important commercial banks were the privately-owned banks, which held a third of the volume of local banking business. As its scale and coverage is determined by the Banking Law, the BPR makes up the remaining share. In addition, although there has been an increasing interest by Muslim customers to perform non-interest financial transactions, the function of the Islamic banks was insignificant, as the networks have only been established in Yogyakarta city and the surrounding suburban areas.

Previously (section 4.4) it was noted that the GDRP of financial sector has grown significantly in the last few years. The evidence suggested that the trend was driven by aggressive promotion of commercial banks for consumer loans, especially to finance motor bike purchases, credit cards and salary-pledge lending. The consumer loan boom did not occur exclusively in the provinces; this also occurred throughout Indonesia since the wage rates in the formal employment sector have increased along with better economic conditions since the financial crisis. The oversupply of consumer credit, however, has been indicated as an early warning about the bad debt problem that would be caused by the impact of declining economic growth and the current global financial crisis.

Following the economic crisis and recapitalisation of the commercial banks, there has been a shift in the focus of banks from corporate lending to microfinance and the SME segments. Further research reveals that several leading commercial banks have become involved in micro-banking and have started to compete in the microfinance market by targeting the bankable micro-entrepreneurs clients of the incumbent providers – the BRI microbanking program, BPR and other semi-formal microfinance institutions. Consequently, the competition among the banks has become fiercer and it would provide broader choices for the customers in conducting banking transactions. In general, however, the emerging micro-banking products and services have not broadened the financial access of un-bankable and low-income clients.

In 2006, the region was hit by a devastating earthquake, which caused hundreds of casualties and destroyed houses, public buildings, schools and business infrastructure including hotels, trading centres and local markets. The quake significantly decreased the local economic activities since large numbers of businesses were damaged, more specifically in the banking and finance sector which accounted for a considerable number of NPLs and numerous borrowers were unable to pay back the loans on time. In order to assist the borrowers, banks extended the repayment schedule without default penalties, and wrote off loans of the deceased borrowers and those completely incapable of rebuilding their businesses. However, there was a relatively small impact of the quake on the NPL, which was 0.2 per cent in Yogyakarta's banking sector (BI 2009a).

The semi-formal financial institutions such as the state-owned pawnshop (Perum Pegadaian) and KSP/USP and BMT have been an alternative source of finance, since these institutions apply simple procedures and competitive interest rates or profit sharing. According to BAPPEDA-DIY (2010) Perum Pegadaian, in 2009, had 28 outlets and accounted for loans of half a trillion IDR, and served nearly a half million clients, including a small Islamic-based pawnshop. This institution has enjoyed a monopoly market for over a century, but recently its pawn business has been shared with the newcomers – the Islamic banks and BMTs – which are regulated by the government regulations. See Chapter 5 for a detailed discussion on the microfinance sector.

The KSP and BMT play major roles in the lower socio-economic segments of the population and the informal economic sector. As community-based financial institutions, the cooperative microfinance organisations serve microenterprises and marginal clients who have difficulty in accessing formal banking services because they are assessed as un-bankable, lack assets for collateral and fail to or are unable to provide formal documentations.

It is difficult to obtain accurate information regarding the financial performance of the cooperative microfinance sector, their clients and network outlets. However, as an indicative figure, there are around 143 KSP and 200 BMT institutions in the DIY regions, and most are concentrated in the district of Sleman, Yogyakarta city and Bantul. Generally these institutions operate near the local marketplaces as their clients are traders and microenterprises. Only a few of the loan and saving cooperatives finance farming activities, the exceptions being the subsidiary units of village cooperatives. Another provider, although less significant, is the local-government microfinance program.

Informal financial and unregulated microfinance providers have been in existence for a long time and are embedded in the socio-economic structure of societies. There are many forms and modus operandi of the informal microfinance providers in Yogyakarta. Prominent moneylenders are the primary actors in the informal financial markets (Soegiarto 1993). The easy access to them, their friendly procedures and quick availability of loans make the moneylenders attractive, but the simple processes contrast with the interest rates that can be more than 100 per cent per annum. The underlying reason for the excessive loan price is to mitigate the risk of non-collateral credit, and to cover associated costs of the financial transaction, i.e. daily loan collection.

Rotating loan and saving associations (*Arisan*) are a traditional financial intermediary mechanism in the communities. *Arisan* is embedded in the socio-cultural system and reflect the values of solidarity, cooperation and mutual trust of the members. Technically, each member periodically saves a specific amount of money for a certain period to pool funds, and later each member can obtain a loan through random selection; both savings and loans are free of interest, although sometimes there is a small donation for administrative cost and charity. In addition, there are other sources of loans in the rural village communities including landlords, shopkeepers and traders. The loans are mainly in kind and agricultural inputs – seed, fertiliser and pesticide – and repayments are made after the harvest period in the form of agreed commodities, i.e. rice. The other common source of financial loans is friends and relatives, who often provide loans on very flexible terms and conditions. In addition, the provincial government run microcredit programs. For example the Bantul district administration initiated a microcredit scheme for poor households (*Pemberdayaan Ekonomi Keluarga Miskin* or PEKM) (Kompas 2010).

It is common that finance follows business, which in Yogyakarta means that the financial market serves both the formal and informal sectors. The commercial and state-owned banks tend to serve the better-off and bankable business ventures as well as providing microfinance for micro and small enterprises that constitute a substantial portion of the local economy. In the informal domain, the semiformal and unregulated financial providers with flexible financial transaction arrangements serve the untapped market of the informal and microenterprise sector, self-employed and lower socioeconomic households. However, there is no rigid line that divides the formal, semiformal and informal financial systems, since the institutions interact and are interrelated in the circulation of money in the local communities. To conclude, the state of financial intermediation and markets in Yogyakarta is influenced by the socioeconomic structure, which is supportive of the growing microfinance sector.

4.6. Summary

Yogyakarta is a special region at the heart of the Javanese culture. It demonstrates distinctive socio-cultural, religious and economic attributes. The mixture of Javanese traditions and Islamic teachings have infused the communities with ideals of social harmony, tolerance, cooperation and mutual respect. These religious and socio-cultural attributes are supportive of the cooperative ethos, including faith-based microfinance institutions.

Poverty is a challenge for the government and society. The roots of poverty are mainly related to environmental constraints and the structure of the local economy which is related to subsistence agriculture and lower wages. Recently, there has been a decline of the agricultural sector; in contrast, trade and tourism, especially craftsmanship, the informal and microenterprise sectors, have emerged as the economic drivers. In an economy with a dominant informal sector, a semi-formal financial system – in particular community-based microfinance models – are critically important. The operation of these institutions in the communities is inter-woven with the nature of inhabitants' livelihoods. The following chapter examines the microfinance sector in

Indonesia and identifies diverse types of microfinance programs and their operational platforms, including recent developments in the microfinance sector.

CHAPTER 5

THE MICROFINANCE SECTOR IN INDONESIA

The Indonesian microfinance sector is very complex and its development has been influenced by political motives and policies of the government as well as the socio-cultural and religious beliefs of the society. Structurally, this sector is under the umbrella of the banking and financial industry, which embraces both conventional and Islamic financial models.

Numerous studies have been conducted to review and examine the institutional arrangements, supply and demand, regulation and supervision, sustainability, outreach and impacts of Indonesia's microfinance systems. However, without wishing to present redundant discussions overlapping with previous studies, this discussion of the microfinance sector aims to provide a comprehensive portrait of the microfinance sector and particular issues that are associated with the central questions of the thesis, that is, to examine the dynamic roles of BMT as an Islamic community-based microfinance institution. To understand the microfinance sector thoroughly, this discussion will also continue into Chapter 6 and Chapter 7.

The first section introduces the general structure of the microfinance sector and the variety of microfinance providers, both conventional and Islamic-based approaches that have had a sustainable presence in the societies. A review will be presented of the historical development of microfinance from the colonial period until the current stage, and the involvement of the government in influencing the microfinance sector will be discussed. The subsequent discussion reviews the most recent developments of micro banking, particularly to examine the growing involvement of commercial banks in microfinance, and the rural bank (BPR) in the banking landscape, including the roles and performance of cooperative microfinance (KSP) and several community-based microfinance institutions such as BKD, LPD, BKK, and special case of Perum Pegadaian. The third section reviews the government's microcredit guaranteed program (KUR) and the newly established revolving fund institution (LPDB).

5.1. Microfinance Sector Development

Microfinance has been practised for over a century and the sector comprises diverse approaches, institutional forms, legal status, products and services. The earliest financial arrangements in this country existed in local societies under trade transactions, individual debt, and other socio-cultural and economic relationships (Henley 2009). The financial contract was informal, and comprised individuals and group of people, and its motivation included commercial and social orientations.

Furthermore, this traditional financial system developed through the introduction of the popular credit system (*Volkscredietwezen*) by the Dutch colonial administration and indigenous Javanese elites in the 19th century. The movement was influenced by the Raiffeisen cooperative model in Germany and other European countries (Henley 2010; Steinwand 2010) and it was also motivated by the growing concern of reformist Dutch politicians and bureaucrats toward poverty in rural communities and excessive moneylending practices.

The establishment of the *Volkcredietwezen* model was highly accepted by local elites, hence it was developed across the colonial territories. Accordingly, the government established village banks (*Bank Desa*) and paddy banks (*Lumbung Desa*) but these community-based organisations were localised only in the Java island as the main agricultural region. In short, Steinwand (2010) points out that these institutions were structurally transformed, becoming a pooling fund institution (*Centrale Kas*) and merged into *Algemeene Volkscredietbank* (AVB) respectively. Furthermore, the presence of the local financial institutions had led to more demand for credit in the communities, and with the need to widen loan accessibility, the colonial regime established a state-owned pawnshop institution that originated from European practices.

The Dutch regime initially developed the microfinance sector through a subsidised approach, however the programs experienced financial constraint particularly when the government eliminated budget subsidies. Also, the subsidy system was perceived by the people as a charitable program, therefore it led to moral hazard and a high level of loan defaults. Following this, after several experimental projects and lessons learnt from past experience, the government adopted a mixed approach by combining subsidised and commercial approaches. Financial support was given in the initial stages of the programs, and so the institutions were gradually evolved along commercial lines. It seemed the approaches could achieve the objectives of sustainability and idealistic missions to provide credit access to the inhabitants (Steinwand 2010). The policies were adopted by the Indonesian government following independence, and the dual system, the subsidised and commercial approaches, remains in the microfinance sector until the present time.

After independence, between 1945 and 1967, the Old Order (*Orde Lama*) regime struggled to stabilise the political condition and to restore the unity of the nation that in effect was underdeveloped (Hawkins 1955). In this period, the colonial banking and financial system was nationalised but its function was paralysed due to the country experiencing massive economic degradation and hyperinflation. At the same time, the microfinance sector was integrated into the national financial platform and one of the policies was to convert *Volkscredietbank* into *Bank Perkreditan Rakyat* (BPR) but these local banks were underdeveloped (Steinwand 2010). Furthermore, the change of government policy in early 1968 led to the revitalisation of the financial and banking sector,[33] and it led to the microfinance sector becoming politically important to the New Order (*Orde Baru*) government.

The cornerstone of microfinance development was during the Green Revolution or *Bimbingan Masal* (BIMAS) program. The BIMAS program was designed to to achieve food self-sufficiency and to alleviate chronic poverty in rural areas. The program comprised technical agricultural assistance, and on-farm loans to support peasant farmers to produce rice and food commodities. The credit scheme was subsidised by the government budget and it was managed by Bank Rakyat Indonesia through the bank's village office network (*BRI Unit Desa*). Subsequently, the central bank restored the BPR sector; the policy objectives of this were to regulate and supervise these financial institutions, and to sustain their role as community banks. The government also converted the colonial village bank system in the Java region into the Village Credit

[33] The government overhauled the banking system by introducing the Central Bank Law, and the establishment of Bank Indonesia. This was followed by the enactment of the Banking Law and a restructuring program of the government banks such as Bank Rakyat Indonesia (BRI), Bank Negara Indonesia (BNI), Bank Dagang Negara (BDN), Bank Ekspor Impor Indonesia (BEII), Bank Tabungan Negara (BTN), Bank Pembanguan Indonesia (Bapindo) and Bank Pembangunan Daerah (BPD). Following the financial crisis in 1998, BDN, BEII and Bapindo were merged into Bank Mandiri.

Institution (BKD) and infused additional capital to increase their lending capacity; BRI was also authorised to act as a supervisory agency on behalf the central bank.

Another progressive policy to widen financial access in the rural areas was the establishment of local financial institutions such as District Credit Institutions (BKK), the Rural Fund and Credit Institution (LDKP) and the Rural Credit Institution (for examples LPD in Bali province and LPN in West Sumatra province); there were other government microfinance programs established by the provincial administrations. In addition, the government sponsored the establishment of rural cooperatives (KUD) and saving and credit cooperatives (KSP/USP) to channel funds into villages and the communities. These government policies caused the number of microfinance institutions to flourish, and more importantly, the massive flow of subsidised micro loans into the agricultural sector was successfully in supporting the rice self-sufficiency program and reducing the incidence of poverty in the rural areas.[34]

After a decade of the BIMAS program, the government faced a massive budget deficit[35] if it were to continue the subsidised agricultural loans and to recapitalise the *BRI Unit Desa* losses (Robinson 2002). Therefore the government introduced a new banking policy in June 1983, which reduced the credit ceiling and placed control on interest rates with the central bank. Banking sectors were encouraged to mobilise public savings instead of relying on government funds. Under this banking regulation framework, the *BRI Unit Desa* was transformed into a commercial microfinance format (and accordingly, the *BRI Unit Desa* was renamed as *BRI Unit*) by providing credit, saving and other financial services to various low-income segments of the population. The bank also moved the office premises close to business centres, extended the microfinance units in urban areas. The transformation indicates the importance of the rural finance paradigm shift (Robinson 2001) and it inspired a new wave of the global

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[34] Besides on-farm subsidised loans, the *BRI Unit* Desa introduced non-subsidised mini/midi credits to finance off-farm income-generating activities of farmer households. Furthermore, in 1974, the government launched several government-funded credit programs and credit guarantee schemes such as KIK/KMPK and cooperative loans. The KIK/KMKP credits were aimed to foster the development of indigenous entrepreneurship and the coop loans were intended to sustain political involvement of the New Order regime in the cooperative sector.

[35] The main sources of subsidised loans were surplus income from the booming petrol price as an impact of the oil embargo of the Middle-East countries, and concession loans from donor institutions (i.e. the World Bank) and aid assistances (i.e. the USAEED). The decline of oil prices and aid funds from US and other donor countries severely affected the continuity of the government budget to support the cheap credit policies.

microfinance industry[36] that adopts a market-oriented approach and a greater variety of commercial financial services beyond traditional microcredit (Robinson 2002).

The progressive impact of the 1983 banking reform and strong economic growth in the mid-1980s encouraged the government to introduce other liberal banking and financial policies (PAKTO 1988 and PAKMAR 1989) that fostered the rapid development of new private banks, foreign banks, and a spectacular increase of new BPR outlets due to a relaxation of the initial capital requirement (IDR 50 million) for a new BPR (Holloh 2001). The liberalisation of the banking and financial sector generated a huge amount of bank lending that was disbursed into the market and brought about economic overheating. In response, the government introduced tight monetary policy and withdrew subsidised liquidity loans channelled by the government-owned banks including KIK/KMKP loans for SME, and program loans for cooperative and agricultural sectors. The result of this government policy was to drive the banking sector – especially the state-owned banks – to compete in the commercial market, but these banks also maintained their missions as agents of development.

Accordingly, the central bank obliged all banks to allocate 20 per cent of their credit portfolio to small business credit (*Kredit Usaha Kecil* or KUK). This regulation was aimed at ensuring equal treatment among the banks and at maintaining continued access of the MSE sector to loans. In addition, Banking Law No. 7/1992 was enacted, which reclassified the banking structure into two types: the commercial (primary) bank and BPR. The law allows the commercial bank and BPR to carry out conventional (interest-based transaction) and profit-based sharing or *Sharia* banking. Another significant implication of the new law for the microfinance sector is that it endorses sound BKK, LDKP and BKD and other local government-initiative microfinance institutions to be able to obtain BPR licenses (Steinwand 2010).

Broadly speaking, during the era of the New Order, the state banks, especially BRI, were dominant in commercial microfinance, although the government continued to support the non-bank microfinance programs and selected subsidised microloan

[36] BRI established the International Visitor Program (BRI-IVP), a desk dedicated to promoting the *BRI Unit* microbanking system in international forums and to providing training programs to other countries regarding the management and operation of commercial microfinance. It is also worth noting that Bank Dagang Bali influenced the new approach of saving in microfinance; unfortunately the bank became bankrupt due to mismanagement and lack of good corporate governance.

programs which were mainly associated with poverty alleviation programs (BWTP 2009). The major targets of the programs were to empower farmer and fisherman, poor household, self-help community group, and other sector-oriented subsidised credit programs. Apart from the aforementioned microfinance institutions, NGO-based microfinance also emerged; this was inspired by the success of the Grameen Bank in Bangladesh and funding support from international NGOs and aid agencies. Recently a new approach to the Islamic microfinance system (BMT) has been introduced by Muslim scholars whereby, in effect, the microfinance sector becomes more complex (see further discussion in chapters 6 and 7).

Another turning point in the development of the microfinance sector was the financial crisis of 1997–98. The financial turmoil affected the banking system with impacts which brought many banks into bankruptcy and several leading both state-owned and private-owned commercial banks were bailed out by the government.[37] Since the crisis was associated with large corporations and foreign exchange debt, most banks with less exposure to corporate loans and foreign exchange transactions – for example BRI, with a large portion of its credit portfolio in microfinance and SME loans – survived and quickly recovered from the crisis (Patten et al. 2001). The catastrophe has also changed the domestic economic structure whereby the SME sector has become stronger as the backbone of the country's development. As a consequence, this shift has influenced the nature of supply and demand for micro and small loans. Banks have reoriented their businesses by entering the microfinance and SME markets. To some extent, the financial disaster has become a blessing for the proliferation of the non-bank microfinance sector both in the number of institutions and in the financial transaction volumes. The roles of these institutions were to substitute for the absence of financial intermediaries in the banking sector by serving the MSE and informal sectors, and to provide financial support for poor people and others living under the poverty line. These microfinance services were part of the post-crisis poverty alleviation programs such as the social safety net and the program to support less-developed villages.

[37] The impact of the crisis included the massive closure of 83 commercial banks, BPR and the nationalisation of 13 private-owned banks through recapitalisation programs; several of these banks were merged. Accordingly, three state-owned banks (BBD, BDN, BEII) were merged into a new bank (Bank Mandiri).

After the crisis, the banking and financial industry was restructured through the amendment of the banking law (Banking Law No. 10/1998), and the central bank imposed a stricter regulatory and supervisory system such as capital requirements, risk management practices, and it allows foreign investors to hold up to a 99 per cent share of commercial bank ownership; however foreign ownership in the BPR sector remains forbidden. In addition, the government has established new financial institutions: Pemodalan Nasional Madani (PNM) and Lembaga Pembiayaan Dana Begulir (LPDB). PNM was assigned to replace the function of the Bank Indonesia in channelling subsidised credit schemes. More specifically, this institution is dedicated to supporting the microfinance and SME sectors. LPDB has been designed to manage revolving funds from the government budget (*Surat Utang Pemerintah* or SUP). This organisation operates under the Ministry of Cooperative and SME (MENEGKOP-UKM), therefore its focus is more on providing funds to cooperative microfinance. In brief, the microfinance mainstream has been driven into the commercial market and the capitalistic system, while the subsidised approach has become a matter for minor policy and inclined to political motives. Most recently, the government has launched two poverty alleviation schemes: the community empowerment program (PNPM-MANDIRI) and Self Help Group of Poor People (*Kelompok Usaha Bersama* or KUBE),[38] and a new credit guarantee scheme for microenterprises and small businesses (*KUR-Ritel* and *KUR-Mikro*), which are channelled by six state-affiliated banks such Bank Mandiri, BNI, BRI, BTN, BUKOPIN and Bank Syariah Mandiri (BSM); the *KUR-Mikro* is distributed by the *BRI Unit*.

The microfinance sector has also been influenced by non-institutional microfinance providers that operate beyond the government's influence and regulations. Generally, this informal microfinance mainstream has developed in association with the socio-cultural backgrounds of communities over several centuries. This provider typically comprises an individual person, for example a moneylender and trader, and groups of persons or entrepreneurs working through a rotating saving and credit association (*Arisan*).

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[38] The programs are designed for villagers to conduct multiple anti-poverty activities including microfinance services.

Currently, a rough estimation is that microfinance providers reach 52,170 outlets and these institutions serve more than 62 million borrowers and 45 million depositors,[39] however, the discussions following are only focused on regulated microfinance as presented in Table 5.1.

The contemporary microfinance sector is quite complex and it encompasses diverse types, approaches, modus operandi, and it numbers thousands of active microfinance institutions. In general, microfinance is more focussed on microcredit rather than saving and other financial services, which are equally demanded by the low-income clients. The banking sector and government influences are dominant in shaping the mainstream of microfinance. The government interest in microfinance is still critical and its involvement is driven by political motives, since the microfinance sector is an element of the government's strategy in alleviating poverty and local economic development. The most common involvement of the government is through ownership, regulation, supervision and policy design, funding and capacity building.

It is worth noting that the demand side of the microfinance market is very complex and highly diverse with respect to the socioeconomic backgrounds and socio-cultural characteristics as well. The common theme that has been used to define microfinance beneficiaries are prosperity indicators such as income, assets and other socioeconomic indicators. In this respect, the popular terminology commonly used is: 'destitute' and 'poor' for people who live under and at the official poverty line level and 'non-poor' for people above the line. Another method refers to the poverty alleviation toolbox model, which defines the client segments into three categories: 'extreme poor', 'economically active poor' and 'lower-middle income' (Robinson 2001). Also, there are several more approaches but these have similar features and attributes.

[39] In this study, data are collected from various sources such as Bank Indonesia for BPR (2007), Bank Rakyat Indonesia for BRI-Unit (2008), the Ministry of Cooperative and SME for credit and saving cooperatives (2005), and Profi-GTZ for some semi-formal MFI and BMT (2002). These figures do not include regulated microfinance under the local governments and unregulated providers.

Table 5.1. Regulated Microfinance Arrangements

Category	Legislation	Supervisory Agency	Modus Operandi	Financial Methodology	Ownership	Outreach
Microbanking	Banking law	Bank Indonesia	Banking	Conventional Islamic-based transaction	Government Private (domestic and foreign-ownership)	National Regional Local
Cooperative microfinance	Cooperative Law	Ministry of Cooperative and SME	Membership loan and saving coop	Conventional Islamic-based transaction	Group of people	National Regional Local
Non-bank and non-coop microfinance	Provincial and district regulations	Local government agency Provincial-owned bank (BPD)	Membership loan and saving institution	Conventional approach	Local government Village administrations	Sub district Village
Government-owned microfinance	Ministry of Finance regulation	Ministry of Finance Ministry of State-owned Company	Pawnshop Venture capitalist	Conventional Islamic-based transaction	Government	National

Sources: Holloh (2001)

In Indonesia, from the perspective of microfinance providers, the market is generally defined into two classifications: bankable and un-bankable segments. The bankable client – who is also known as the economically active poor (this typology is used by BRI and other commercial banks) – refers to an individual, household and/or micro-entrepreneur who is creditworthy as demonstrated by a sustainable source of income, holds asset(s) and/or saving that can be used for loan collateral., In a broad perspective the customer has passed the '5 C analysis': character, capacity, capital, condition and collateral. In contrast, the un-bankable or low-income clientele who are poor and self-employed earn less than USD 2 per day and are vulnerable due to their low and irregular income and other financial risks, since they lack savings and have few assets. In those cases, in microfinance terminology those clients are un-bankable. This segment is not served by microfinance programs and they are excluded from the finance system.

5.2. The Microbanking System

By law, the Indonesia banking sector is regulated by Banking Act No.10/1998 and the earlier Banking Act No. 7/1992 for the conventional banking system, and Banking Act No. 21/2008 for the Islamic bank. The banking acts define two groups of banks: commercial banks and BPR. The fundamental differences between the two types of bank are mainly in capital requirement, ownership, modus operandi and geographical coverage as summarised in Table 5.2.

Table 5.2. Typology of Microbanking

Subject of Regulation	Commercial Bank	BPR
Minimum capital	IDR 3 trillion	IDR 2 billion if the operation covers the capital city, Jakarta; IDR 1 billion in other provinces; IDR 0.5 billion in other areas
Ownership	Open both for domestic and foreign investors – foreigners can own up to 99 per cent of shares	Limited to Indonesian citizens only
Modus operandi, product and services	All banking services	Unable to provide checking accounts – no access to the clearing system, prohibited from foreign exchange transactions
Coverage	National	Restricted based on capital

Source: compilation from Bank Indonesia regulations

Learning from the financial crisis, , the central bank has recently introduced Indonesia Banking Architecture (API) Bank Indonesia that comprises six policies to strengthen the soundness of the banking industry, risk-based supervision, good governance, and customer protection. The API classifies banks into five categories that are based on capital fulfilments: international bank, national bank, focused bank, community bank and BPR (BI 2009a).[40] In addition, the commercial bank and BPR are required to engage in a deposit insurance system to protect public savings and deposits. The insurance deposit scheme is provided by *Lembaga Penjamin Simpanan* (LPS) and the banks' participation is compulsory through a basic insurance premium mechanism that is calculated based on the amount of public funds that is handled by each bank.[41]

The regulatory and supervisory body for the banking system is Bank Indonesia. The Central Bank Act No. 23/1999 states that the roles of Bank Indonesia include licensing,

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[40] Bank Indonesia imposes new regulations on BPRs in order to strengthen their capacity. These include increasing the minimum capital requirements for new BPRs, certification for the board of directors and sound risk management measures.

[41] LPS is established under Law No. 24/2004. Initially, the amount of saving and deposit covered by LPS is IDR 100 million. Currently, since the global financial crisis, the amount guaranteed has increased to IDR 2 billion.

regulating and supervising.[42] Bank Indonesia directly supervises both commercial banks and BPR through on-site and off-site supervision. On-site supervision is conducted periodically, i.e. once a year or at any time when it is needed, or if a problem arises (by special audits), while off-site supervision is based on the banks' obligation to submit periodical reports such as weekly, monthly, half-yearly and annual reports, as well as any information required by the regulator. Bank Indonesia uses the international CAMEL[43] framework to assess the soundness of banks, as well as operating as an early warning system to identify potential problems that might occur.

The terminology of microbanking refers to commercial microfinance services, which are provided by commercial banks and BPR. The root of the microbanking system was initiated by BRI as a result of the successful transformation of the *BRI Unit Desa*, and the introduction of liberal banking policies in 1983. The BRI microbanking system (*BRI Unit*) is a business unit of the bank that is controlled and supervised by a branch office.[44] *BRI Unit* mainly offers general rural credit (*Kupedes*), passbook micro saving (*Simpedes*), and remittance and payment services. In 2008, there were approximately 4417 *BRI Unit* offices across the provinces and overall *Kupedes* loans outstanding of nearly IDR 42.8 trillion owed by 4.4 million borrowers. Interestingly, it accounted for a very low rate of non-performing loans (NPL) at 1.02 per cent. In saving, the performance *Simpedes* reached IDR 55.1 trillion and recorded 18.7 million saver

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[42] The Central Ban Law defines the supervisory function of Bank Indonesia. It should have be taken over by the bank's superintendence authority at the end of 2002, however it has been a pending issue until now.

[43] The CAMEL system consists of seven ratios of capital adequacy, the quality of performing assets, profitability, liquidity and 25 qualitative questions to assess general and risk management. Each element of CAMEL is computed using a scale from 0 to 100, then weighted according to the assigned weight. Banks that achieve 81–100 points are regarded as 'sound', 66–80 classified as 'fairly sound', 51–65 categorized as 'less sound' and below 51 are considered 'unsound'. In addition, a bank exposed to unlawful practices, such as internal conflicts, outside interference in management, or 'window dressing' is automatically categorized as 'unsound'. The weight of the CAMEL components between a commercial bank and BPR differ; for example capital is weighted at 25 per cent for a commercial bank and 30 per cent for BPR; and management at 25 per cent for a commercial bank and 20 per cent for BPR.

[44] BRI is a publicly-listed bank in which the majority of its shares belong to the government. The mission of the bank to provide the best banking services for microenterprises, and small and retail businesses as well as the corporate segment. In doing so, the approach of BRI is to develop a broad range of products, channel distributions and approaches that fit to the characteristics and the preferences of each segment:

1. Poverty alleviation program for clients below the poverty line.
2. Program loan for customers above the poverty line such as subsidised loans for supporting agricultural and cooperatives development.
3. Microbanking that is targeted to active working poor and microenterprises such as commercial microcredit, microsaving and other financial services.
4. Small and medium enterprises banking for established SME businesses.
5. Corporate banking, particularly agribusiness companies, state-owned enterprises and other companies that link to the micro and small enterprises sector (BRI, 2012).

accounts. At the end of 2008 calendar, *BRI Unit* reported IDR 6.2 trillion, 9.8 per cent returns on assets (ROA) and 14.3 per cent returns on earning (ROEA) respectively. It is equally important to note that *BRI Unit* has sustained its performance and significantly contributed to the recovery process of the bank during the financial crisis in 1998 (Patten et al. 2001).

The outstanding achievement of *BRI Unit* has attracted a great deal of commercial interest in microbanking, particularly after the economic turmoil. Inevitably, the systemic crisis has changed the landscape of the banking industry. The banking system was in a state of collapse and nearly all banks faced tremendous losses and failed to comply with regulations for continuing their operation. As a result, many banks were closed, so the number of banks decreased from 222 to 164, and several major banks were taken over by the government through recapitalisation and restructuring programs (Abdullah and Santoso 2003). Accordingly, the crisis also transformed the structure of business, as the role of microenterprise and SME, along with the self-employed and informal sector had been a strong driver of economic growth and employment. As the sector emerged, several leading commercial banks with nationwide networks, such as Bank Danamon, Bank Mandiri, BUKOPIN, BTPN, Bank Mayapada, and Bank CIMB Niaga, establish microbanking divisions and expand their coverage into suburban areas. Most recently, more foreign-owned commercial banks, i.e. Bank Andara,[45] and foreign banks such as Citi Bank, HSBC and Standard Chartered Bank, have entered the microfinance market to lead fierce competition in a similar market segment.

Commercial banks are motivated by profit to enter the microbanking sector, since microcredit typically generates a higher interest margin than corporate loans (Nazirwan 2007). The commercialisation of microfinance is also influenced by the favourable political and economic environment. There are huge market opportunities, especially unbanked microenterprises, as the most recent survey of the International Finance Corporation (IFC) in Indonesia reveals the potential demand of MSE on diverse financial products and services including saving, ATM use and remittances (Franedya 2010).

[45] Bank Andara was originally a local bank in Bali. It was acquired by a consortium of Mercy Corps, International Finance Corporation (IFC), Stichting Hivos-Triodos Fund (HTF), and Catholic Organisation for Relief and Development Aid (Cordaid).

Among the commercial banks, the *BRI Unit* has been a pioneer, and also a market leader; it also holds the highest microcredit portfolio. However, in the past few years, Bank Danamon has doubled the DSP network and has been an intense competitor of the incumbent bank through their 'speed, simplicity and convenience' approach including developing a mobile team and sales forces to reach out to more potential clients, particularly in traditional market places. Bank Mandiri employs a hybrid strategy through direct relationships with microbanking clients and a strategic alliance or linkage program with BPR[46].

Discussing the presence of BPR is often confusing since the terminology has been used in different ways along with its history (Holloh 2001; Steinwand 2010). The origin of BPR is in the Dutch colonial village banks and trader banks (*Bank Pasar*) and LDKP which emerged in early 1960 and then newly established BPR after the second banking reform in 1988 or PAKTO 1988.

As presented in the previous discussion, under the banking law, BPR is permitted to operate a dual banking system – both conventional and Islamic or *Sharia*-based transactions, however, these institutions are excluded from operating within the central bank clearing system, prohibited from conducting foreign exchange transactions, and their operational coverage such as within district or province or across provinces is associated with the amount of paid in capital. BPR is an open enterprise operation, which means that government, a private company, a cooperative, a group of people and individuals could own the bank, but it is prevented from being under direct foreign ownership. The rational argument behind the restriction is to protect the local economy from international capitalists, although the argument is possibly irrelevant, particularly since Bank Indonesia allows foreign ownership to fully control commercial banks that operate freely in both urban and rural areas.

BPR and its networks exist in almost all provinces, however the majority of BPR outlets operate across the Java regions and Bali (2774 units or 81 per cent); in contrast, only a small number are present in the eastern provinces or in other less-developed regions.

[46] The linkage program between commercial banks and BPR and microfinance institutions was initiated by Bank Indonesia. The general linkage model is that commercial banks provide loans to BPR and microfinance institutions so that they may re-lend the funds to the end-borrowers. This mechanism includes direct loans, a two-step loan and channelling credit, therefore it would ease the constraint of the microfinance sector to obtain liquidity for credit expansion and institutional growth.

After the liberal PAKTO 1988 policy the booming BPR sector was allowed a smaller capital requirement (IDR 50 million) to establish a new BPR and for the legal conversion of eligible LDKP and BKD outlets into the BPR operation. However, the dramatic growth of BPR was not properly supervised by the banking authority, and so there were many BPRs that were mismanaged and bankrupted during the financial disaster.[47] To strengthen the capacity of BPR, Bank Indonesia has developed a certified training program for BPR management, mainly for the Board of Directors. The certificate is mandatory for candidates for directorships, as well as for existing BPR directors. The certification program was accomplished in 2008 as targeted, by which time existing BPR management should be formally certified.

On the whole, the performance of BPR shows a positive trend and stable growth, which is reflected by healthy and strong financial indicators such as total assets, loans, savings, profitability and sustainability over the past few years. In 2008, total assets and loans outstanding were the highest yet, although the totals were far below the other microbanking counterparts (BRI Unit and DSP). However, significant disbursement in lending also led to a substantial increase in NPL and it was clear that the BPR loan quality had deteriorated, especially when it was compared against the BRI Unit and the average of the commercial banks' performances. This negative sign should be taken account of by the central bank, which should intensifying supervision on lending practices and the general prudential banking principles, and needs to increase non-performing loan provisions and the capital adequacy ratio as well.

The exponential growth of microbanking, to some extent creates a tension between commercial banks and the BPR association (PERBARINDO). The BPR association objected to the growing presence of leading commercial banks in the markets that traditionally are served by BPR. As Sunarto (2007) points out, the commercial banks, i.e. DSP, aggressively enter the bottom and top of the microfinance segments by using its competitive advantages as a full banking intermediary to attract new clients, and the existing customers of other financial institutions. PERBARINDO claims that the newcomer to microbanking only takes advantage of well-established customers, instead

[47] In the aftermath of the crisis, Bank Indonesia has closed nearly 386 units of BPR, in which the majority of the unsound BPRs lacked adequate capital and suffered massive losses due to huge non-performing loans including insider fraud scams.

of penetrating unbanked markets, therefore the BPR association urges the central bank to revise the banking architecture policy that should clearly define the geographical operation of commercial banks and foreign banks in order to maintain healthy competition.

Also, there is a concern that the commercial banks' staff recruitment policies threaten the BPR and other microfinance institutions by offering better salaries to their employees, career development prospects and social prestige as a banker. In response, the banking authority ensures equal treatment to support the BPR sector and encourages the commercial banks to engage in the linkage program and strategic alliance with the BPR. However, these policies have not lessened the competition in the microbanking market because the banks' strategies tend to expand the networks and to build up their own customer base.

The increasing development of the microbanking sector has expanded the availability of financial services in the communities, especially for bankable clients and sustainable microenterprises, and it also leads to fiercer competition in the market. Charitonenko et al. (2004) point out that the rivalry within commercial microfinance would benefit the clients through better prices and service, more product choices, and would permit microbanking to penetrate into untapped segments. Quite recently, for instance, the *BRI Unit* has responded to the competition by reducing the Kupedes loan interest rate and developing Teras BRI to reach out to new customers, beyond its core market and its bankable customers.

5.3. Cooperative Microfinance

Cooperatives are recognised in the constitution (*Undang Undang Dasar* or UUD 1945). The essential spirit of the cooperative system includes a collective economic force, mutual cooperation and solidarity; these are important factors in achieving national development and prosperity of the nation. The cooperative system is not a new issue; historically it has been practised over a century since the colonial period, and naturally it acts as an economic agent in the communities. The foundation of the cooperative sector is Law No. 25/1992 and other implementing regulations, i.e. government regulation No. 9/1995 that specifically regulates KSP/USP. Furthermore, MENEGKOP-UKM introduced a decree No.91/2004 to accommodate the proliferation of BMTs.

The general cooperative supervisory framework is adopted from the banking system (CAMEL) but it has been adjusted to comply with the nature of the cooperative system. The supervisory function is mainly performed by MENEGKOP-UKM and its subordinated agency in the provincial and district administrations. The MENEGKOP-UKM only supervises KSP/USP with a national license, while the coop, which holds regional licenses are overseen by the provincial and district administrations respectively. However, this autonomous supervisory system faces a disadvantage in coordinating the government agencies in order to establish an effective supervision mechanism.

The KSP development has been influenced by the government's interest, particularly during the New Order regime (BWTP 2009). The KSP sector has been involved in channelling subsidised funds to specific target groups and the government programs which are linked to farming activities, and informal micro enterprises. Holloh (2001) points out that the coop system remains under the political domain of the government, therefore this sector was beyond the target of the financial reform policies. The recent regime still maintains its political support and the policies have been aimed to build a strong and healthy cooperative sector by improving management capacity, governance and funding support. However, these initiatives have not been effectively implemented since MENEGKOP-UKM and its subordinate agencies face a budget deficiency and lack capable staff to record and oversee the large number of cooperatives. The ambiguity of the law enforcement process has contributed to the unsatisfactory performance of KSP and the whole cooperative sector.

The present state of the cooperative sector is a product of its evolution. Holloh (2001) summarises three typologies of KSP. The majority of them are cooperatives under the influence of government, and strongly controlled by a group of elites. Their operations are highly dependent on external subsidised supports. The typical institution is a village cooperative (*Koperasi Unit Desa* or KUD), which was established to support particular projects and missions to implement political agendas of the government. In effect, nearly all of the programs commonly are financially unsustainable. In addition, the widespread nature of the government's subsidised microfinance services has distorted the financial market (Robinson 2001) and created a strong impression in the local communities that the cooperative loan scheme is actually a means for charitable grants.

Another common setback has been the misuse of funds by management due to lack of supervision and control from the authority and members.

The presence of insufficient regulation and supervision of the cooperative sector has been used by a number of individuals and/or groups to decide to establish a financial intermediary similar to a formal bank. This is another type of cooperative which has solely business and profit motives; the cooperative licence is only a legal structure, thus, it allows the organisation to mobilise saving from the members (in most cases pre-membership) and enjoys other incentives as a loan and saving cooperative institution. Naturally, the modus operandi has the characteristics of a predator lending institution rather than a cooperative, and often this type of KSP is abused by the management for their own vested interest, including the operation of Ponzi schemes.

The last variant of cooperative microfinance is designed and established as a grass-roots movement. This model of KSP is managed and controlled by the members, and is financially self-sufficient. There are several successful models of KSP that use different names; among those is *Kospin Jasa*, which was established by an association of market traders and entrepreneurs. The other example of a sustainable local cooperative microfinance is *Koperasi Kredit* (KOPDIT), whose operational methodology adopts international best practice as a credit union.

The linkage model between commercial banks and KSP is another interesting microfinance cooperative. This system, at one end, allows the bank to extend financial services to cooperative members and to generate profits from the services. At the other end, the KSP gains access to funding, technology, personnel training and technical assistance. For example, BUKOPIN established a linkage model with KSPs through the SWAMITRA program (Bank Bukopin 2013).

In addition to primary cooperatives, there are secondary cooperative institutions (*Induk Koperasi* or *Pusat Koperasi*). The principal role of a secondary coop is as an apex institution, which provides an inter-lending facility among the member institutions, and management of surplus funds. However, the general performance of secondary cooperatives has been marginally unsatisfactory due to liquidity constraints, insufficient support from cooperative members and poor management of assets and liabilities. An exceptional example of a successful secondary coop is the apex institution KOPDIT, which is supported by the World Council of Credit Unions (BWTP 2009; Holloh 2001).

Technically speaking, the mainstream cooperative experiences exhibit a deficiency in supervision compared to its counterpart, the microbanking sector. As a consequence, there is no reliable data and information that thoroughly depicts the real picture and performance of coop microfinance. A statistic of MENEGKOP-UKM (as of March 2005) places the total number of KSP/USP at 38,083 units, including the Islamic cooperative microfinance sector. Of that figure, approximately 1598 were KSP and 36,465 were USP, and both KSP/USP manage total loans of IDR 14.7 trillion, savings of IDR 1.8 trillion, and had 5.5 million members.

Cooperative microfinance plays an important role in broadening financial access to the un-bankable population. As member-based financial providers, the cooperatives are an appropriate tool for poverty alleviation, through which financial resources are circulated in the communities to the ultimately benefit of the members. In practice, however, the cooperative system is very complex. This sector faces chronic shortage of funds since it is not included in the government’s deposit insurance system. Another internal impediment is weak management capacity, which influences the overall performance of the cooperatives. Furthermore, there is insufficient supervision both from their own supervisory boards and members, as well as by government agencies. There has also been strong government political intervention which has served to weaken the microfinance programs of the cooperatives. In summary, although, the number of cooperatives and their memberships is extensive, the cooperatives’ share of the overall microfinance market is relatively small.

5.4. Community-Based Microfinance

The general term ‘community-based microfinance’ refers to a non-bank and non-cooperative microfinance institution and it is referred to by different names such as BKD, LPD, BKK and LDKP. The majority of those institutions belong to village communities and are formally under the control and supervision of local government. In this section, three institutions (BKD, LPD and BKK) are selected as case studies, as representatives of successful community-based microfinance programs.

5.4.1. Village Bank

The origins of village banks (BKD) can be dated back to the early 1900s when the Dutch colonial administration established village paddy banks (*Lumbung Desa*) and village banks (*Bank Desa*) on the islands of Java and Madura. The colonial administration formally regulated BKD in its Staatsblad No. 357/1929 relating to village credit institutions, and assigned the *Algemeene Volkscredietbank* (AVB-Bank) to supervise them. After the colonial period, the existence of BKD was not specifically mentioned in the Banking Act of 1967, and so the Ministry of Finance granted a collective business license to BKD. In the New Order administration, the sustainable BKD institutions were transformed into BPR, while the under-performing BKDs continued to operate with the assistance of BRI and the Ministry of Interior Affairs (Holoh 2001).

BKD is owned and managed by the village administration and supervised by BRI on behalf of Bank Indonesia as regulated under *Staatsblad* No. 357/1929 and Banking Act No. 21, 1968. The central bank bears the supervisory costs, which are calculated based on an annual budget prepared by BRI. In addition to its regulatory oversight function, BRI provides loans to capitalise the BKD, sets loan interest rates, maximum loan sizes and savings interest rates. BRI is responsible for ensuring effective internal control of the BKD. At BRI head office there is a designated supervisor (*Mantri*) to oversee 20–30 BKDs based on a regular monthly schedule.

The BKD organisation is a very simple and lean operation that comprises a board made up of members of the head of the village as a chairman, a village secretary and a finance officer. In addition to the board members there is a bookkeeper who is responsible for managing the financial record and administrative duties. The bookkeeper is appointed by local government and that person works at five to six BKDs that operate on different days of the week. The BKD operates on specific days each week, mostly on market day. It provides loans on a membership basis which are repaid on a weekly payment system (for loans of up to 12 weeks period), a monthly instalment basis (for loans of up to a 12month term) and on a seasonal instalment method which is associated with agricultural activities. The loan process is very simple: there is no written application and a minimum of documentation. This standard operating procedure is designed to reduce operational costs and to streamline the loan process since the majority of clients are un-bankable and have low educational backgrounds. In addition, BKD offers a voluntary saving option with an interest rate set at 2 per cent below the interest rate of the *BRI Unit*'s passbook saving (*Simpedes*), hence this mechanism allows BKD to earn income from the investment of surplus funds in *Simpedes*.

In brief, the BKD sector has been effective in reaching un-bankable and low-income inhabitants, particularly in rural and remote areas in the Java region where *BRI Unit* and other microfinance institutions are not represented. In this respect, this microfinance system acts as an entry access point into the formal financial system for un-bankable clients. Apart from the predominant role of these institutions in poverty reduction and microenterprise development programs, however, the BKD system faces chronic deficiencies of good corporate governance, a lack of competent staff and a shortage of funding for business expansion, hence the sustainability of BKD institutions is highly influenced by the local administration support (Ravicz 1998).

5.4.2. Village Credit Institutions

In early 1980, the Ministry of Interior Affairs encouraged local governments to establish microfinance institutions (LDKP). In response to this call from the central government, the Balinese provincial administrations established their own microfinance model which was labelled a village credit institution (LPD). The distinguished feature of the LPD system is that it is owned and managed by the village custom (*Banjar*)[48] but with regulatory and supervisory control in the hands of the provincial government, which is in effect carried out by the regional development bank (BPD Bali). The BPD Bali also provides technical assistance and credit lines including treasury services to manage the excess funds of the LDP institutions (Arsyad 2006; Holloh 2001).

Similar to BKD, the generic LPD institutional arrangement comprises a board of management which is selected from the senior and respectable member of the *Banjar* structure. Interestingly, this recruitment system allows the uniqueness of the Balinese socio-cultural values to be embedded in the organisation, and this social control system has become a solid foundation for the sustainability of LPDs (Arsyad 2006). Apart from

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[48] *Banjar* is a socio-cultural term that represents the origin and social relationship of the Balinese communities. *Banjar* is ruled by Hindu customs and tradition, hence it differs from *Desa Dinas* (a village under the government administration), defined on a geographical territory and is overseen by a sub-district government. Instead, *Banjar* is comprised of several *Desa Dinas* and is highly autonomous, whereby the organisational structure and leadership system is elected through a general election.

the supervisory board, the LPD operation is conducted by a chairman, an accountant, a treasurer and field marketing staff or a loan officer. This is a generic structure for LPDs, but it can be larger and more complex according to the development of the institution. The LPD operates throughout the week and offers loan and saving services for community members.

The basic lending product is a multi-purpose loan, with an instalment plan comprising daily, monthly and seasonally systems, and the loan terms between 100 days to 36 months. The interest rate ranges from 30 per cent to over 70 per cent per annum, depending upon the loan types and the local market (i.e., competition with other microfinance institutions and money lenders). The saving instruments encompass compulsory (tied to the loan) and voluntary deposits (passbook saving and term deposits).

The saving services offer quite a competitive return, on average slightly above the interest rate of the commercial bank. The distinguishing socio-cultural features of LPDs are its very simple and quick procedure and client-visit approach, which have been the key drivers of the institution in attracting funds from the communities, hence it is common that the majority of the LPD financial structure is dominated by third-party liabilities (saving and deposit).

In general, the LPD sector is relatively more sustainable than other community-based microfinance systems. However, it is very evident that the variability of the LPD's performance depends on the local socio-economic backgrounds and business infrastructures. Arsyad (2006) points out that the performance of LPD in tourism areas is better than that in agricultural districts. Actually, the typical discrepancy (which is also present in the DIY province) is driven by the type of tourism activities that generate dynamic economic activity compared to the seasonal and low-turnover farming system.

In conclusion, the LPD system is an excellent example of a community-based microfinance system which is owned and managed by the members, and where the benefits are returned back to the community. In addition, the LPD sector plays a substantial role in opening financial access in the villages across the Bali province and contributes to local economic growth. Despite its weaknesses and constraints, the LPD institution can be adopted for socio-economic empowerment and poverty alleviation as well.

5.4.3. Sub-District Credit Institutions

As mentioned in an earlier section, during the New Order regime, the local governments were encouraged to establish microfinance programs to support the anti-poverty and regional economic development policies of the central government. In 1970, the Central Java provincial government initiated the establishment of *Badan Kredit Kecamatan* (BKK) in nearly all sub-district administrations. The primary objective was to foster socioeconomic development in underdeveloped regions, particularly through the provision of microcredit facilities for marginal villagers who engaged in off-farm activities, and for other poor people who were not eligible to be included in the BIMAS program of the *BRI Unit Desa*.

The BKK institutions belong to the provincial government and, similar to the LPD system, it is supervised by the regional development bank (Bank BPD Jateng), and the bank also provides treasury management and technical assistance. The BKK sector has developed in terms of institutional numbers, assets, clients and outreach. In addition, in 1992, to comply with central government regulation No. 71/1992, the majority of BKK institutions were converted into BPR (Holloh 2001). The outstanding performance of the BKK sector in the Central Java province has inspired other regions to replicate this model, e.g. in South Kalimantan province (Ravicz 1998).

The generic BKK organisational structure comprises main office at the sub-district level and mobile village units which operate on market days. In the beginning, BKK focused on off-farm lending and short-term loans to low income people for productive activities. The loan disbursement mechanism is via the head of the village but the ultimate decision is made by the BKK management. The distinguished feature of these loans is the non-collateral nature of them, therefore the creditworthiness assessment relies on the character of the borrower and compulsory saving as a default guarantee. The borrower is allowed to choose different types of credit terms, for instances, daily, weekly, monthly and a seasonal basis – whichever is the most suitable to that person’s income pattern, business cash flow and repayment capacity. The interest rate policy is set without the government subsidy and it is charged based on the loan type in the range of 24 per cent to 120 per cent per annum (Holloh 2001). Following the success of

Simpedes of the *BRI Unit*, in 1987, BKK introduced a public saving product (*Tamades*), however its performance and promotion have not been as popular as its counterpart.

The performance of the BKK sector is quite sound but most recently, its sustainability suggests a declining trend due to weak supervision and internal control, and as a typical government-based source of microfinance, BKK faces external interference from the local administration (Holloh 2001). The institutional design of the BKK system, as well as its financial instrument, is appropriate to households which slightly above the poverty line (Hulme and Mosley 1996).

The above discussions regarding BKD, LPD and BKK reveal the important roles of the non-bank and non-cooperative microfinance organisations, and their position in the structure of the microfinance sector. The financial approach, institutional arrangements, products and services of these microfinance providers seem appropriately to serve the lower segment of poor inhabitants, and in particular reach the un-bankable groups which are beyond the target market of the formal banking sector. In this regard, the three institutions play a dual function as a subsystem of the government's anti-poverty policy and also to act as a conduit for better-off low-income and well-established clients and/or microenterprises to access the commercial banking system. Although the community-based microfinance system has a smaller share of total assets, its geographical outreach, especially in remote areas, is critically important. Thus, Holloh (2001) points out that the sustainability of the microfinance providers should be taken into account in order to maintain the availability of financial services in these communities. Among the priority issues are for the regulatory and supervisory framework to ensure good governance and for prudential practices to be in place, and also to bring the sector into the formal financial mainstream.[49]

5.5. State-Owned Financial Institutions

In Indonesia, the regulated microfinance system and governmental-oriented financial institutions play dominant roles in the microfinance market. This section reviews the strategic roles and contributions of the state-owned financial institutions in

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[49] The regulatory and supervisory system of non-bank and non-coop microfinance is stipulated in Microfinance Law No. 1/2013.

microfinance – the state-owned pawnshop (Perum Pegadaian), PT. Permodalan Nasional Madani (PNM) and Lembaga Pengelola Dana Bergulir (LPDB).

5.5.1. State-owned Pawnshop

The state-owned pawnshop or Perum Pegadaian is a pawn broking company that was established during the period of Dutch colonialism. The initial operation was in Sukabumi, West Java and operated by disbursing credit in cash with collateral guarantees. The basic idea of Perum Pegadaian is to help indigenous people to access funds quickly for short-term needs, either for overcoming household budget stresses, or for emergency or business purpose. In a similar way to other microfinance institutions, pawnshops were established by the Dutch government to counter the dominance of the exploitative moneylenders and also to foster local economic development by providing direct access to credit in the communities (Perum Pegadaian 2009).

During the colonialism period, Perum Pegadaian developed by trial and error, and after independence it was transformed into a state-owned organisation (*Perusahaan Umum* or *Perum*). With this legal status, Perum Pegadaian carries on a mission as an agent of development, and is under the supervision of the Ministry of Finance (MENKEU) and the State Ministry of State-owned Enterprises (MENEG-BUMN). The formal status of Perum Pegadaian is unique in the financial system sector since it holds a monopoly right, however, recently the Islamic bank and BMT institutions have been allowed to provide an Islamic pawnshop service which is regulated under both the Islamic Banking Law and the Islamic Cooperative Regulation.

The core business of Perum Pegadaian is to provide short-term loans against specific collateral assets such as household goods, jewellery, vehicles and other forms of portable collateral. In general, the loan transaction process is very fast and the amount is reviewed based on the value of the collateral, on average, 60 to 80 per cent of the market value, ranging from IDR 5000 to IDR 100,000,000. The interest rate is charge based on the loan term and the amount outstanding. The interest rate is calculated every 15 days of the loan cycle: 1.25 per cent for loans less than IDR 150,000 and 1.75 per cent for larger amounts. The loan period is normally up to 15 days period but it can be extended a maximum of twice. If the loan is not paid back, the collateral will be auctioned to cover the principal and interest. It is clear that the business model of Perum

Pegadaian is based on a high turnover and relatively low risk when compared with the microcredit model (Perum Pegadaian 2009).

Lately, the company has introduced a microcredit schemes (*Kreasi* and *Kritsa*) for business and general purposes, for which the loan attributes and procedures are quite similar to the generic microfinance loan, and the Islamic pawnshop service. In addition, Perum Pegadaian provides non-financing products including remittance, auction, gold trading and storage but these businesses are less important.

In 2008 the Perum pegadaian operated a network of 2089 branches, supervised by 13 regional offices. The organisational structure follows that of the government administration, with the head office in Jakarta, regional offices in provincial capital cities, branch offices in districts and sub-districts. There is often an outlet close to the BRI branch. The role of Perum Pegadaian is critically important in providing financial services, since it provides an alternative source of credit to low-income clients when they need access to credit quickly without cumbersome administrative processes (Perum Pegadaian 2009).

Holloh (2001) points out an interesting phenomenon pawnshop business concerning during the economic crisis: the banking sector was reluctance to extend credit, therefore Perum Pegadaian became the major source of lending and liquidity supply in the communities. In 2008, Perum Pegadaian reached nearly 16.6 million clients, majority of whom were farmers, fishermen, traders, and micro-entrepreneurs (Chandra 2009). It can be seen that Perum Pegadaian has been well-positioned among the multiple segments of the microfinance market.

5.5.2. Permodalan Nasional Madani

Permodalan Nasional Madani (PNM) was established under government regulation No. 38/1999[50] with the primary mission to manage 12 program loan schemes of Bank Indonesia. Initially, the function of PNM was to disburse the agricultural plantation credit scheme (*Kredit Koperasi Primer Aanggota* or KKPA), which involves a partnership between farmers, cooperatives and corporate plantations. In a subsequent

[50] Under the new central bank law (No. 23/1999), Bank Indonesia is prohibited from extending liquidity credit schemes and subsidised loans for financing government programs.

development, PNM was extended to channel the government funds for microfinance and the SME sectors (PNM 2004).

PNM manages several funds, which are principally from government sources, including government sub-debt (SUP-005), channelling funds of government institutions and projects, and concession loans from international donors. Although the operation is backed by the state, the nature of the PNM approach is commercially oriented and it is a fully autonomous institution, where the loan decision is solely based on the creditworthiness and sustainability of the targeted institutional clients. In contrast to commercial banks and other state-owned enterprises, the distinctive approach of PNM is to provide capacity-building programs to the microfinance sector. The provisions of training and technical assistance are built in with the loan programs, and the main objectives are to strengthen the institutional management capacity and to enhance the operational system and technology. Through the capacity building programs, PNM gains direct advantages that help this institution to monitor the soundness of loans on a regular basis, and it retains strong partnerships with the microfinance institutions.

PNM is designed as a wholesale financial institution to supply funds to commercial banks, BPR, cooperative microfinance, BMT and other regulated microfinance institutions. The lending model comprises direct financing, channelling and equity participation. PNM also performs as an umbrella or apex institution of BPR and cooperative microfinance organisations as well as BMT. In this regard, PNM and the microfinance associations form the apex organisations, which carry out particular functions such as pooling funds, providing an inter-lending mechanism, an information centre and IT services. At the beginning, PNM owned the majority share and provided most of the funding towards the apex institution, but these were gradually replaced by involvement of the members when the institution had become well established. In addition, PNM established two subsidiary companies focused on venture capitalism and investment funds (PNM 2004).

Quite recently, PNM introduced a microfinance unit (*Unit Layanan Mikro* or ULAMM) to reach out the micro and small enterprises. In essence, the business model of ULAMM is quite similar to that of the *BRI Unit* and other microfinance institutions, whereby it extends microcredit for business and productive ventures. The advantage of ULAMM, besides disbursing loans, is that it is designed to provide technical assistance to the clients, especially in areas of marketing, financial management and information technology. PNM developed from a wholesale financial institution into a retail micro-financing provider. As such, this institution, as a state-owned enterprise, is likely to play a significant role in the microfinance sector. The annual report for 2008 shows that PNM serves over a million beneficiaries (low-income households, micro and small businesses) through different partnership models, with 1500 microfinance institutions and 4000 cooperatives (PNM 2009).

5.5.3. Revolving Fund Institution

The Revolving Fund Institution or Lembaga Pengelola Dana Bergulir (LPDB) is a government public service institution established under government decrees: The Ministry of Finance No.KEP.292/MK.5/2006 and MENEGKOP-UKM No. 19.4/Per/M.KUKM/VIII/2006. The legal status of LPDB is a subsidiary of the MENEGKOP-UKM. The underlying objective of the establishment of the LPDB institution is to maintain the dualism policy of government in the financial system. The LPDB mission is to manage government revolving funds for microenterprise, SME, and cooperative sector. Broadly speaking, it is a means for the government to direct subsidised funds to particular sectors and target low-income population groups (LPDB 2009). From the lessons learned and past experiences, it was realised that direct financial intervention of government organisations, i.e. the MENEGKOP-UKM,[51] would cause corruption and misuse of funds and the bureaucratic system. Instead, a board of management independently runs the LPDB and, unlike in *Perum Pegadaian* and PNM, because LPDB is a public service institution, it has a not-for-profit motive, but its operation should generate sufficient income to cover costs.

The main source of LPDB's funds come from the SUP-005 repayments,[52] and additional money from the government budget (APBN). Every year, LPDB is required

[51] For many years, MENEGKOP-UKM was involved in subsidised financing programs. In 2000, it introduced a revolving fund model in order to support the funding of the cooperative sector. Among the programs were programs to capitalise loan and saving cooperative (KSP/USP), to finance prospective agribusiness, the P3KUM financing scheme, and women and household empowerment (Perkasa).

[52] In 2004, the government issued the first phase of the government sub-debt (SUP-005) with a total outstanding of approximately IDR 3.1 trillion. The fund is channelled through the state-owned banks (BRI, BNI, Bank Mandiri, BTN, BUKOPIN), the regional government-owned banks (BPD), Pegadaian and PNM. The SUP-005 fund is aimed at financing the agricultural sector, small trades and retailers, small industries, handicrafts, and other high-valued commodities and products of micro, small and medium enterprises, informal sectors and cooperatives.

to submit a business plan to the Ministry of Finance, including the amount of funds allocated from the APBN to support the financing plan.

The LPDB's financing scheme is targeted to the un-bankable segments of the population, particularly households and individuals who are involved in productive economic activities and own micro and small enterprises. The initial LPDB financing model was developed in partnership with several commercial banks that have core businesses in the SME sector. Accordingly, LPDB embraces cooperative sectors such as KSP, BMT and apex cooperative institutions, to channel the loans to the borrowers. This strategy is more effective in extending the outreach of LPDB into the communities rather than through banking networks, which are focussed on serving bankable customers. In addition, LPDB has developed a direct financing model for strategic microenterprises and the SME sector, for instance in agribusiness and export-oriented products.

The LPDB financing methodology comprises conventional (interest-based) and Islamic (profit and loss sharing) systems. The interest rate for loans or financing is established based on the co-existence of subsidised and commercial approaches. LPDB disburses the loan to a commercial bank and cooperative microfinance institutions at the central bank rate (the BI rate) plus (e.g. 4 per cent); this rate or price is substantially under the market rate. Subsequently, the banks and coop microfinance organisations charge the client at commercial loan interest rates. This mechanism, at one end, allows the LPDB partners to make sufficient profit to cover operational costs and risk, and, at the other end, to generate enough income for LPDB to maintain the operation.

In general, the LPDB approach is quite promising as an alternative financing mode to remove financial barriers for the un-bankable population with a less-destructive impact on the financial market and banking sector. This institution would be a source of liquidity for non-bank microfinance institutions that are not allowed to mobilise public funds. However, there are several challenges that the LPDB development has encountered.

1. The inherent structure of LPDB allows the government to interfere in the independence of management and the institutional policy, especially in loan assessment and disbursement.

2. Second, as a public service institution, LPDB is part of the government budget system, thus this unique position tends to drive the management to take a risk-averse policy in order to protect themselves against legal action in the case of loan default. in effect, LPDB employs selective loan procedures similar to the banking system, therefore the main objective of the institution to extend their services to the un-bankable clients would not be achieved.
3. Third, there is still a strong perception in the communities that most the government program is charity; in this instance, LPDB should be appropriately positioned as an independent financial institution and adopt good governance practices as well.
4. Finally, lack of human resources and limited networks would be a major limiting factor for LPDB to embrace a significant number of the un-bankable inhabitants.

It is evident that the state-owned microfinance institutions make a direct contribution to the development of the microfinance sector. The predominant role of the institutions is in making basic financial services accessible to the under-served population. It has been demonstrated that Perum Pegadaian and PNM can provide this function. Secondly, the quasi-public agency, LPDB, is also critically important as a means for maintaining the dual microfinance system (subsidised and commercial loans), especially to strengthen the capacity of the cooperative community-based microfinance sector as important frontier microfinance service providers.

5.6. Microcredit Guarantee Scheme

In November 2007, the government launched a new credit scheme, *Kredit Usaha Rakyat* (KUR), to foster the acceleration of the economic sector and the SME sector.[53] Credit disbursement is carried out via six of the government-affiliated commercial banks (Bank Mandiri, BRI, BNI, BTN, BUKOPIN and BSM). Technically, the KUR program is a credit guarantee system in which if there is a default, 70 per cent of the loan outstanding will be paid by two government-owned credit insurance companies (AKSRINDO and JAMKRINDO) and the remaining 30 per cent credit risk is borne by the banks.

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[53] The KUR credit scheme is backed up by the Presidential Decree No. 6/2007 and the Memorandum of Understanding between government and state-owned banks and credit guarantee institutions (*Aksrindo* and *Jamkrindo*).

The government supports this scheme through an additional capital injection to strengthen the capacity of ASKRINDO and JAMKRINDO to guarantee the credit, with a gearing ratio of 10 times, which means that for every IDR 1 of credit, the guarantee would cover IDR 10 of loan value. In fact, the credit guarantee system is not a new approach in Indonesia. The government has implemented it since the 1970s to guarantee KIK/KMKP credit and cooperative sector loans, however the models were not successfully and could not sustain the lending schemes because of a high level of corruption and government intervention. Interestingly, the KUR program has been heavily criticised by politicians who suspect this loan is being used to increase the popularity of the incumbent government. To respond to these concerns, the government has published a campaign in the national newspaper (i.e. Kompas 24 May 2008) that argues that the KUR loan is a part of the anti-poverty strategy (pro-growth, pro-job and pro-poor policies) particularly after the elimination of the petrol-subsidised budget. It also points out that the KUR loan is intended as a 'fishing tool' that can help poor people to fish, instead of just giving them fish.

The first phase of the KUR loan is designed to finance under-served microenterprises and SMEs with loans up to IDR 500 million, but the result and the impact did not satisfy the government, especially the President, as the banks only targeted a small number of the un-bankable population, and it appears that the bank has only served bankable customers in order to minimise the level of NPL. Accordingly, a new KUR-Mikro loan has been introduced specifically aimed at microenterprises and other un-bankable segments. This loan can be up to IDR 5 million and the procedures are designed to be very simple, with lower transaction costs, and with an annual interest rate set to a maximum of 24 per cent. Because KUR-Mikro is very similar to microcredit, BRI Unit has been assigned to channel the loans, and the government is driving BRI Unit to take an active role in reaching out to millions of new clients.[54]

[54] During the period of the introduction of the KUR program, I was head of the BRI branch office in the Central Java province. The pressure from the government through the bank's board of management was very strong. All the heads of regional offices and branch offices were ordered to speed up the rate of loan disbursement. Regardless of the pressure, I decided to take an independent approach by scrutinizing loan applications according to the protocols of prudential banking practices. To monitor the progress of the KUR program, a instant daily report was implemented through short message system (sms) and regular report were made each month.

In a relatively short period, KUR-Mikro has reached over a million clients and the achievement of Bank BRI has been highly praised by the government, however, the mass approach to some extent has ignored prudential banking principles, which in turn will decrease the loan quality and increase the level of loan default (Vebri et al. 2010). The loans outstanding in 2008 totalled IDR 12 trillion and its outreach was nearly 1.6 million borrowers, of whom roughly 1.48 million were microcredit clients. In addition, the KUR loan was largely absorbed by the trade sector (60.13 per cent), agriculture (21.26 per cent) and service (3.27 per cent) respectively.

As the KUR loan's NPL indicates an upward trend, the banks have tended to slow down the disbursement of lending, particularly after the presidential election was over and the incumbent President has begun his second term of office. Looking to the future of the KUR program, the government has redesigned the features of the loan by eliminating some of the rigid and cumbersome procedures, for instance pre-screening of blacklist customers (referring to credit bureau information), as well as lowering the interest rate from 24 per cent to 22 per cent and allowing a loan restructuring option in order to reduce the NPL figure, particularly in favour of clients who experienced financial difficulties as a direct and/or indirect result of the global financial crisis. In addition, existing borrowers are able to extend the loan period up to six years for a working capital loan and up to 10 years for investment credit. Subsequently, the government has increased the loan guarantee fund by approximately IDR 2 trillion to guarantee IDR 20 trillion of new outstanding KURloans. This policy should boost the performance of the microenterprise and SME sectors and the contribution to 55.6 per cent of GDP (Suharmoko 2010).

The KUR loan scheme has shown a positive outcome in terms of the loans outstanding and the number of borrowers, however there is a significant concern about whether this program has achieved its goals to address the financial inclusion of un-banked populations. The evidence from a field study in DIY province reveals that a large portion of un-bankable households and micro-entrepreneurs still have no direct access to this formal banking service. Clearly, it is not a surprising finding because the banks' policy is to favour better-off clients, which are able to fulfil the formal credit requirements, e.g. collateral. It is also equally important to point out that the government is reluctant to extend the KUR loan channel beyond the six existing banks.

It is doubtful that the current administration would lose political control over the KUR program if the loan were administered by other banks and financial institutions.

5.7. Summary

The general portrait of the microfinance sector in Indonesia is as a sophisticated, vibrant and complex range of services that has evolved over a century and has been a proven system in different socioeconomic settings. Structurally, the system is classified into regulated and unregulated microfinance arrangements, and the dual approaches (selectively subsidised and commercial) remain along with the conventional and Islamic systems.

The microbanking mainstream is the dominant providers although they tend to serve the bankable clients, and its networks are mostly in the strategic economic centres. Cooperative microfinance, the non-bank and non-cooperative microfinance institutions play critical roles in broadening financial services to more remote areas and reach out to the un-bankable and un-banked segments.

The role of government in microfinance remains strong, and the dual approach of subsidised and commercial approaches still exits although there has been a change in policy and strategy within the government agencies. It seems that the government has adopted a moderately interventionist school of thought in order to maintain a conducive business environment and stability within the banking and microfinance sectors, and to ensure that the objectives of poverty alleviation and local economic development are on the right track. This government intervention has broadened financial access of unbanked segment, in particular un-bankable microenterprises and poor clients in remote areas as well as in Yogyakarta. The following chapter examines the Islamic banking sector and its current performance and progress, as it is strategically important to the development of Islamic microfinance, specifically the BMT sector.

CHAPTER 6

EMERGING ISLAMIC BANKING AND FINANCE

In the last few years, the Islamic financial system including Islamic banking and Islamic microfinance mainstream has become a growing sector of the Indonesian financial system. Although Indonesia has the world's largest Muslim population, the development of an Islamic finance system has lagged behind that of other Muslim countries including its closest neighbour – Malaysia. There is no doubt that the introduction of the Islamic financial system has involved considerable effort, energy and patience on the part of Muslim scholars and economists. The process has taken nearly a decade and it has been a challenge for Islamic activists to convince the New Order government to introduce the Islamic model into the national financial system and to provide financial and banking services based on the religious teachings of its majority Muslim population.

It is clear that the development of the Islamic financial mainstream has faced many problems and challenges since its inception. Several studies reveal that the delayed introduction of the Islamic financial system was significantly influenced by the political interests of the Suharto government (Effendy 2003), religious discourse among Islamic school of thoughts, and the socioeconomic backgrounds of Muslim societies (Antonio 2004).

This chapter will provide an overview of the Islamic banking sector, in particular presenting the current position and role of the faith-based banking model under the dual banking and financial system. The introductory section addresses the endeavour of Muslim elites to initiate the Islamic banking system under the repressive government regime. The following section discusses in detail the emerging performance of the Islamic commercial banking sector and the Islamic microbanking sector. Furthermore, to provide a thorough picture of the industry, a brief description pertaining to the Islamic pawnshop and charitable funds (ZIS) organisations are presented as well. Finally, the last part of the discussion presents the challenges of the future for Islamic banking which has the potential to become a new mainstream of the financial system.

6.1. The Inception of Islamic Banking

The Islamic banking and finance system was embarked on in the mid-1970s after the establishment of several Islamic banks in the Middle East and other Muslim countries. It developed further particularly when Indonesia took a supportive role in the initiation of the Islamic Development Bank (IDB). However, the idea of introducing the Islamic banking system was only discussed in informal forums due to the state's strong control of the Islamic movement, and in addition there was no legal framework to support the establishment of an Islamic bank, or any established model of faith-based banking.

During the New Order administration, President Suharto, with the strong backing of the national army, strictly limited the expression of Islamic ideology and other related activities in the public domain by introducing a single political ideology of *Pancasila* (Effendy 2003). In the first decade of the Suharto regime, the Islamic mainstream within the society and many aspects of the socio-religious affairs of Muslims were undermined through the introduction of secular policies (Federspiel 1998).[55] In the economic sector, although Indonesia is a supporter of the establishment of the IDB, the government and the central bank's positions were clearly opposed to the idea of Islamic banking, particularly during the banking liberalisation era between 1983 and 1988 (Antonio 2004). On the contrary, the President was more in favour of supporting an association of Indonesian-Chinese entrepreneurs. Basically, at that time, the government experienced a historical and traumatic attitude of phobia toward the idea of Islamic nation.

The breakthrough for the initiation of Islamic banking was in the early 1990s. Along with the gradually changing political environment,[56] the Indonesian Islamic Council *(Majelis Ulama Indonesia* or MUI) conducted a national forum to address the issue of interest rate payments in conventional banking, however the forum failed to reach a consensus regarding *riba* and the payment of interest, because among the inner circle of Islamic scholars and influential Muslim organisations, the interpretations about interest-

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55 The government attempted to secularize the Islamic marriage law but it was opposed by a majority of moderate Muslim elites, including the prominent former Vice-President Muhammad Hatta (Antonio 2004).

56 The Islamic mainstream was under the oppressive rule of the Suharto regime for nearly two decades. Finally, at the beginning of his seventh presidential term, Suharto gradually embraced Muslim elites and non-political organisations. This study presents only a brief overview of the political situation during the New Order regime. Discussions of the Suharto administration and its political system have been presented in many studies such as in Federspiel (1998), Effendy (2003) and Antonio (2004).

based financial transactions was divided. Instead of becoming involved in a counterproductive argument, the Indonesian Association of Muslim Intellectuals (*Ikatan Cendekiawan Muslim Indonesia* or ICMI),[57] and well-known Muslim entrepreneurs proposed to establish an Islamic bank. The advocates of the proposal were sceptical, but eventually the proposal gained the overwhelming personal support of the President (Antonio 2004). The change of the Suharto government's attitude towards Islamic banking was a political compromise that developed in the struggle between the government, the armed forces and others parties led by ICMI.

Accordingly, in 1992 the government enacted a new Banking Act No.7/1992 which included its implementing regulations such as the Decree No. 71/1992 regarding the Islamic rural bank (BPRS)[58] and the Decree No. 72/1992 pertaining the commercial Islamic bank (BUS). For the majority of Muslim activists, the endorsement of the Islamic banking system via the new banking law was an indicator of the great success of the Islamist movement. However, considering the political implications, the wording of the banking act did not use the religious (Arabic) terminologies; the law instead uses 'profit and loss sharing banking' terminology instead (Sjahdeini 1999), and the proposed bank has been named Bank Muamalat Indonesia (BMI). In this regard, the strategy used by the Islamic bank proponents is quite similar to the Turkey Finance House case, which was established in 1980 by eliminating the religious symbol in the law and on the institution's name (Abdul-Rahman 2010). In addition, the implementation of the Banking Act No.7/1992 formally allows the conventional and the Islamic banking models to operate in the financial market. This dual banking policy is quite similar to the Malaysian banking system (Sjahdeini 1999).

It is also important to note that the enactment of the legal framework for Islamic banking has been also recognised as a milestone in the revival of the Islamic microfinance movement, since the central bank received overwhelming support for new

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[57] In 1990, B. J. Habibie, the Indonesian ministry of Research and Technology (later to be appointed Vice-President; in 1998 he became the third President when Suharto was forced to resign from the political arena), led the initiation of the Islamic Intellectual Association (*Ikatan Cendikiawan Mulsim Indonesia* or ICMI). ICMI was a non-political organisation and its objectives were mainly to alleviate poverty and improve access to education in Indonesia.

[58] BPRS stands for *Bank Pembiayaan Rakyat Syariah* or Islamic rural bank, while BPR means *Bank Perkreditan Rakyat* or the conventional rural bank. The terminology of credit (*Kredit*) in the Islamic banking system is replaced by financing (*Pembiayaan*) terminology.

BPRS operations across the Java and other regions. The Muslim activists, entrepreneurs and some leading Islamic-inspired organisations took advantage of the modest initial capital requirement of only IDR 50 million and the very loose administrative requirements to set up the banks (Antonio 2004).

The Islamic banking sector in Indonesia encountered a long battle and political challenge since its inception until the changes under the New Order government. It is worth noting that the adoption of the faith-based financial and economic system is a landmark in the renaissance of the Islamic movement, and progress has been even faster during the last term of the Suharto presidency. At present, the Islamic teachings flourish in various forms of ideological, political, socio-cultural and economic development.

6.2. The Islamic Banking Sector's Development

In the early stages of the development of the Islamic banking sector, the BMI and BPRS in particular faced a dilemma since the banking system was predominantly conventional in character. Arifin (1999) states that the lack of non-interest-based monetary instruments was one of main limitations for Islamic banks to function under the *Sharia* framework.[59] In many cases, the banks were forced to engage in conventional transactions. Furthermore, Antonio (2004) identifies several fundamental constraints that hindered the development of the Islamic banking sector, including tax treatment, the accounting system, lack of capital and appropriately trained personnel.

In consequence, the Islamic banking sector had difficulty competing with the dominant conventional sector, as well as expanding its own networks and increasing its market share. As an example, the Islamic banks faced double tax treatment in mark-up financing, with the consequence that its financial products were less attractive than the interest-based loan schemes although mark-up financing provided some advantages to borrowers. In the period before the financial crisis, the Islamic banking sector

[59] To ensure the bank operation complies with religious jurisprudence, the Islamic council (MUI) established an internal supervisory board (*Dewan Pengawas Syariah* or DPS) in the BMI organisational structure. The primary task of DPS is to produce Islamic-compliant guidelines and to monitor the overall bank transactions as well.

comprised of only one commercial Islamic bank (BMI) and 11 BPRS, which together accounted for less than one per cent of the overall banking market share.[60]

In 1997 the banking and financial sectors were hit by the Asian banking crisis, in which numerous banks were closed and others were bailed out by the government (Batunanggar 2002; Djiwandono 2005). Interestingly, although the magnitude of crisis was huge, and severely hit the country's economic and the banking industry, a number of Islamic banks achieved very sound performance and successfully maintained sustainable growth and profitability (Antonio 2004). In this respect, the Islamic banking system shows its resilience and strength, since the principle of Islamic banking is related to the real economic sector and prohibits speculative transactions (see further discussion in Chapter 2). Another relevant explanation is that most of the Islamic banks were involved in the micro and SME finance segments, which are resistant toward the global financial turmoil with their focus on foreign exchange-based and derivatives financial contracts.

Following the financial crisis, the Islamic banking sector made considerable progress, particularly when the Habibie government changed the banking laws: Banking Law No. 10/1998 and Bank Indonesia Law No. 23/1999. These regulatory frameworks provide a stronger legal foundation for the Islamic banks to play a more significant role in the banking and financial market. Moreover, during the short period of Abdul Rahman Wahid's presidency and the Megawati administration, the central bank introduced a number of substantive policies to foster Islamic banking and it networks. For instance, the conventional banks were allowed to offer Islamic banking services (UUS) under the banks' existing organisational structure. Through this mechanism, the conventional banks were able to establish UUS with modest capital investments and conduct an Islamic banking business with the same infrastructure as their established services (Juaro 2008).

In order to enhance the stability of Islamic banking, subsequent monetary policies have been introduced by the central bank such as the Islamic central bank certificate (SWBI), interbank money market (PUAS) and an emergency financial facility if any Islamic

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[60] During this era, new Islamic financial institutions such as insurance, a multi-finance company and a mutual fund were established both by the government-owned companies and by the private sector.

bank faces liquidity problems (Antonio 2004). Equally important, in within the central bank organisational structure, a new Islamic banking bureau (later it became the Directorate of Islamic Banking) was set up to control and supervise the Islamic banking sector including the design of a grand strategy for the development of Islamic banking (The Indonesian Islamic Banking Development Blueprint 2002–2011). This blueprint provides a general platform and foundation for Islamic banking development and, more specifically, it enhances the structure of the industry so that it is as strong as the conventional banking sector through improving its efficiency and service quality, and ensuring it complies with standards of global Islamic banking.

In line with the banking reforms, the Indonesia Islamic Council (MUI) formally set up the National Islamic Board (*Dewan Syariah Nasional* or DSN) with the primary role to publish *Fatwa* regarding Islamic banking operations and other related economic and commerce transactions, and the National Islamic Arbitrate Body (*Badan Abritrase Syariah Nasional* or BSSN) to mediate any business dispute beyond the formal jurisdiction. According to Hasanudin (a member of DSN), another important milestone was in December 2003 when MUI ultimately declared the status of the conventional banking transactions as *Riba Nasiah*, which means that every Muslim is recommended to abandon interest-based practices immediately (interviewed on 18 May 2009). It is quite interesting to note that the MUI *Fatwa* was introduced five years after the fall of the Suharto regime, but despite this, MUI was not confidence of making the decision without significant support from the Islamic political elites and civil society leaders.

Recently, in the era of President Susilo Bambang Yudoyono, the legal platform of the Islamic banking sector has been further advanced by the introduction of three fundamental acts: the Islamic Banking Law No. 21/2008, the Islamic Bond (*Sukuk*) Law No.19/2008 and Tax Law No. 42/2009. The enactment of these laws enable the Islamic banking and financial sector to operate on an level playing field and to raise the confidence of Muslim customers to engage in financial transactions according to their choice of faith (BI 2010b).

Table 6.1. Legal Framework of the Islamic Banking and Finance Sector

Law category	**Impact on Islamic banking sector**
1. Islamic Bond Law No.19/2008	Allow the government and private sector to raise funds by selling bonds under the Islamic finance system. This law provides a broadened money market for the Islamic banking sector.
2. Islamic Banking Law No.21/2008	The law specifically regulates the Islamic banking sector. One of the key issues in this law is the establishment of an Islamic banking committee. This committee works under the coordination of the central bank to formulate policies and practical guidelines for the Islamic banking sector.
3. Tax Law No.42/2009	The amendment to this law reduces value-added tax toward the mark-up financing contract. This tax-neutral status would increase the competitiveness of the Islamic banking financing scheme.

Source: Author compilation from Bank Indonesia Regulations

6.3. Islamic Commercial Banking Performance

The provision of a new law from the government and a supportive regulatory framework from Bank Indonesia, together with the clear position of MUI about *Riba* and the payment of double interest, has enhanced the development of Islamic banking. In line with the banking reforms (Juaro 2008), many new accounts with BUS and UUS, belonging to the conventional banks, and BPRS have been established. The number of outlets has also more than doubled. The ownership of the Islamic banks (BUS and UUS) consists of the government-owned banks, private conventional banks and foreign banks. The ownership of the BPRS ownership is mostly associated with Islamic organisations and Muslim entrepreneurs.[61]

In contrast to the development of BMI, the newly established BUS, such as Bank Syariah Mandiri (BSM), Bank Mega Syariah (BMS) and Bank Syariah Bukopin (BSB), were originally conventional banks.[62] These banks were converted into Islamic banks, thus benefiting from a central bank regulation stipulating a lower initial capital requirement. Uniquely, the conversion of the banks, from conventional to Islamic was related to the banking rescue program instituted following the financial crisis of 1997–

61 Overseas ownership is not allowed for BPRS; this policy is similar to the counterpart BPR sector.

62 The parent company of BMS is Bank Mandiri (a state-owned bank). BMS is Bank Mega (a national private bank) and BSB is Bank Bukopin (partly owned by the government).

98. Prior to conversion, these banks had almost collapsed due to massive non-performing loans, mismanagement and lack of capital. In these cases, the establishment of Islamic banks was more related to business considerations rather than influenced by political or religious considerations. These conversions were enabled by the less-rigorous requirements for capital in Islamic banks (Juaro 2008).

It is evident that the establishment of new UUS is facilitated by the central bank regulation that allows the conventional banks to own Islamic bank business units. The pioneers of leading government-owned banks such as Bank BRI, Bank BNI and Bank BTN, including some BPDs, set up their own UUS for different reasons and objectives. For examples, Bank BRI established an UUS business in anticipation of a government policy change regarding the Islamic Pilgrim Funds (*Ongkos Naik Haji* – ONH) collection; Bank BRI is a market leader in collecting ONH. Several cases of BPD reveal that the local government-owned banks opened their UUS units because of local political interference, and some others only follow the 'nice to have' trend rather than develop UUS units as a long-term profitable banking business. The private banks and foreign-ownership banks' expansion of their business into the Islamic banking sector is driven by the increasing demand from affluent Muslims for Islamic-compliant banking services.

At the end of 2009, the total number of Islamic banks totalled six BUS, 25 UUS and 138 BPRS. In addition to BMI (the first BUS), 3 BUS were established through conversion, and two others resulted from the expansion of UUS (spin-offs from their parent conventional banks). These BUS own 701 branch offices and the UUS run 286 units. These are the leading players, with networks across 33 provinces and 89 districts (BI 2010c). The overall performance of the Islamic banking sector reveals promising progress with a stable annual growth in total assets, a loan (financing) portfolio,[63] public deposits, good geographical coverage and increasing customer numbers.

[63] The terms of loan and financing is interchangeable.

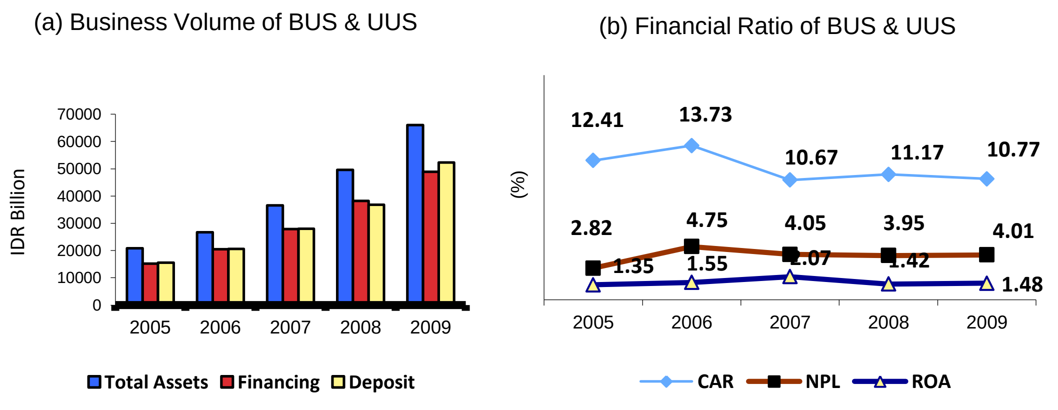
Table 6.2. Key Performance of Islamic Bank Sector

Financial Indicators	**2005**	**2006**	**2007**	**2008**	**2009**
1. Total Assets	20,880	26,722	36,538	49,555	66,090
2. Loan/financing	15,270	20,445	27,944	38,199	46,886
3. NPL (%)	2.82	4.75%	4.05%	3.95%	4.01%
4. Deposit	15,593	20,672	28,012	36,852	52,271
5. LDR (%)	97.75	98.90	99.76	103.65	89.90
6. Profit	298	414	628	605	832
7. ROA (%)	1.35	1.55	2.07	1.42	1.48
8. Network					
BUS	3	3	3	5	6
UUS	19	20	26	26	25
Outlets	550	637	782	1,024	1,223
9. Customers	1,400,588	2,364,561	3,358,059	4,363,275	5,114,699

Source: BI (2010c)

Total assets of the Islamic commercial banking sector reached nearly IDR 66.1 billion, which comprised outstanding loans of IDR 46.9 billion, public deposits of IDR 52.3 billion and service to over five million clients. In the last five years BUS and UUS performance grew more than triple in assets, loans and deposits (see Figure 6.1a). Although there was a sharp decline, particularly during the period of slowing economic growth and the global economic crisis in 2008, the overall financial performance of BUS and UUS is relatively sound and healthy (BI 2010c).

Figure 6.1. Trend of Islamic Commercial Bank 2005–09



Source: BI (2010c)

In a detailed analysis, apparently the rapid development of the sector seems related to the sharp increase of the number of BUS, UUS and their outlets, which allow predominantly Muslim customers and business owners to access a variety of faith-based financial products and services. The Islamic commercial banks have been quite aggressive in disbursing funds to the communities for which the ratio between loan and deposit (LDR) is nearly equal and far above the conventional counterpart rates. The banks maintain a high LDR in order to maximise idle liquidity into profits because there is a very limited opportunity for the bank to invest excess funds in non-interest money market instruments (Juaro 2008). In addition, the BUS and UUS financing scheme is mainly focused on simple transactions, i.e. mark-up financing (*Murabaha*), instead of developing complex PLS financing (*Mudaraba* and *Musaraka*).

The 2009 figure shows that mark-up financing accounted for more than half of the BUS and UUS portfolios, while PLS comprised only one third (BI 2010c). It seems that this strategy has been successfully in fostering the growth rate but in the long-term perspective the concentration on one type of financing model and the lack of portfolio diversification would be riskier particularly in regards default of loans. In other words, Ismail (2010) notes that majority Islamic bank faces overwhelm challenges in applying the PLS financing concept, and although the model underlies the core of non-interest banking and finance, the Islamic banks tend to be selective because of the agency problem[64] and unpredictable return risks. Given the complexities of PLS the method has been modified to a revenue-based contract (Muljawan 2002).

On the liabilities side, the source of funds is mainly term deposits and passbook saving. For the deposit products, the Islamic banks employ a risk guaranteed PLS system that deposits of up to a certain amount are insured by the government-owned deposit insurance company (Muljawan 2002). In this case, in the event of bankruptcy, the banks shift the risk (loss) to the government as ‘the last of the lender resort’. The advantage of the deposit insurance system is that it provides strong confidence for the depositors to

[64] The agency problem derives from the principal-agent theory that demonstrates how one individual (the principal) can design a contract which motives another person (the agent) to act in the principal's interest. The principal-agent problem is driven by two situations: firstly imperfect information, and secondly misaligned incentives between the principal and agent. Imperfect information occurs when the principal cannot sufficiently monitor the agents' actions, i.e. in the Islamic banking practice it is very difficult to monitor the actions of its borrowers especially in PLS contract (Alexander 2006, p.18).

place their money in the Islamic banking sector.[65] In spite of there being a guarantee mechanism, in general, the capacity of Islamic banks to mobilise public funds is relatively low due to a combination of several factors, including a false understanding of customers toward the PLS system, as it is perceived as providing lower returns, and some uncertainty as to the interest-based system, limited network presence in the communities and the competition force of conventional peer banks.

Despite the fact that the Islamic banking sector has performed well, it has not reached its potential market of Indonesia's Muslim majority population. Its market share is less than two per cent of the whole banking industry and below the target of the central bank's blueprint (Juaro 2008). Furthermore Juaro identifies that the performance of UUS significantly contributes to the poor achievement. As a small division of the conventional banks, UUS programs have difficulty in matching, let alone surpassing, the parent bank's conventional performance.

Equally important, from the perspective of options for clients, regardless of their religious motivation, the Islamic banks' products and services mirror the conventional banking instruments and the banks' Islamic strategies are likely to follow those of the conventional programs, including positioning programs in similar market segments. From an overall perspective, the Indonesia Islamic bank sector takes advantage of a niche market of Muslim clients who seek an alternative banking system that is appropriate to their faith. In other words, despite there being fierce competition between the Islamic and the conventional banks, the later remains dominant.

In the international market, according to World Islamic Banking Competitiveness Report 2013–14, total assets of the Indonesia Islamic banking and finance industry sector in 2012 shared only 1 per cent; it was far behind the global leaders (Ernst & Young 2013). Compared to the closest Muslim country, Malaysia, where the Islamic banking system has been in existence for over three decades, Indonesia's Islamic banking sector was only 10 per cent of the size of Malaysia's Islamic banking sector (KFH 2010).

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65 The public funds, for instance current account, term deposit and saving, that are mobilised by BUS, UUS and BPRS are guaranteed by the government-owned deposit insurance company (LPS).

6.4. Islamic Microbanking Development and Performance

The Islamic microbanking system was embraced since the first faith-based commercial banks (BMI) and Islamic rural banks (BPRS) were established. The banks offer several types of Islamic-compliant microfinance and MSE financing to their clients through the PLS system, mark-up financing, leasing, debt and benevolent loans. The Islamic banks are involved in the microbanking business in several ways, for instance, direct and indirect models. The former works in a similar way to the unit banking model, where a bank sets up its own unit business and outlets to reach the ultimate clients. The later, or a linkage, program is a partnership between the banks, BPRS and BMT to deliver financial services into the communities.

By and large, the leading BUS and several UUS engage in the Islamic microbanking sector. The pioneer has been BMI which employs both models through providing a non-interest financial scheme via its own branch offices, and establishing a partnership with BMT and BPRS as extension channels (Arifin, 1999). Historically BMI, in collaboration with MUI and PINBUK, have been the initiators of the BMT system, and the latest BMI program is to support the establishment of 500 new BMT (popularly called BMT Shar-E). With this alliance, BMI provides technical assistance by providing a standard operating procedure (SOP) and an information and technology (IT) system to the start-up BMT. In return, these BMT partners are to promote the bank’s card-based saving (Shar-E) to the communities and the mobilised funds should be placed with the BMI. The primary objective of the BMT Shar-E program is to increase the contribution of SME financing up to 70 per cent of the overall portfolio (Republika 2009). Beside a linkage with BMT and BPRS, BMI collaborates with Pos Indonesia (the government-owned post office) in reaching Muslim customers beyond the bank’s outreach, including channelling the government’s microcredit program (KUM3) to stimulate rural microenterprises and household-based productive economic activities.

Bank Syariah Mandiri (BSM) a subsidiary of Bank Mandiri, the biggest Islamic bank, also embraces a similar model to the BMI approach. The bank established an Islamic microbanking division in the head office and field operational units called BSM micro-shops (*Warung Mikro*) within its branch networks. The micro-shop outlets provide diverse financing schemes ranging from start-up funds (PUM-Tunas), growth funds

(PUM-Madya) to established clients (PUM-Utama), and offers financing amounts from IDR 2million up to IDR 100 million (BSM, 2010). As a subsidiary of a government bank, the BMS micro-shop has been appointed to disburse the microcredit guarantee scheme (KUR-Sharia) along Islamic bank principles. However, the growth of the KUR-Sharia is still far below that of the KUR-Mikro (interest based) of the *BRI Unit*. In addition to its own microbanking system, BSM is involved in the linkage program by extending loans to BPRS, loan and saving cooperatives (KSPs), BMTs and other non-bank institutions including Perum Pegadaian.

In contrast, according to Eko Sukapti (Business Director of Bank Mega Syariah or BMS) the bank employs a direct approach through brand name Mega Mitra Syariah (M2S). The M2S outlets mainly operate near traditional markets and other suburban business centres in Java and Sumatera; the network comprises over 200 branches (interviewed on 23 August 2009). The nature and growth strategy of M2S is akin to its competitors, i.e. DSP (the conventional microbanking unit of Bank Danamon) that focuses on financing the well-established SME sector and the upper-bankable clients who are keen to switch their business to *Riba*-free banking transactions. This approach allows the bank to maintain low operational costs and to achieve economies of scale within a short period of time, instead competing in the lower-bankable segment where the BRI Unit prevails.

The indirect approach is adopted mainly by UUS. This model is quite effective since majority UUS own very limited offices. Similar to the linkage program of BUS, the financing partners of UUS are BPRS, BMT and other Islamic microfinance organisations (Antonio 2004). The alliances executing financing largely by buying and selling contracts which generate several advantages to UUS, such as increase outstanding financing with very economical operational costs, and at the same time it minimises financing risk since the ultimate customers are under the control of the UUS partners. It is also important to explain the growing role of Bank BRI Syariah (BRIS) and Bank Syariah Bukopin (BSB). These Islamic banks are owned by BRI and Bank Bukopin, the leading conventional microbanking institutions. The banks' market share has grown, however their position in the microbanking sector would be a problem because the banks are likely to compete with their parent banks.

Table 6.3. Leading BUS in Islamic Microbanking as of 2009

Bank	Loan (IDR billion)	Share (%)	Network (unit)	Microbanking Approach
BSM	16,063	5.5	390	Direct (Warung Mikro); linkage (BPRS/others)
BMI	11,428	39.4	286	Direct (KUK scheme); linkage (BMT/BPRS)
BMS	6,022	69.5	320	Direct (M2S)
BRIS	1,644	-	58	Direct (IB-Micro); linkage (BPRS/BMT)
BSB	1,279	-	41	Direct; Linkage (cooperatives)

Source: Annual report and financial statement; banks' websites

It is common that the BUS and USS Islamic microbanking networks operate in a similar market to that of their conventional counterparts. The banks prefer to serve well-established bankable clients by promoting Islamic religious values including using Arabic terminology and other socio-religious features. According to a Bloomberg report, small- and medium-enterprise financing have been the most important portfolios of the Islamic banks (Permatasari 2010).

According to the central bank, in 2009 microbanking and SME financing schemes accounted for 76.4 per cent of the Islamic commercial bank sector and the loans were predominantly concentrated in multi-service and trading sectors, and for consumption purposes. However, the Islamic microbanking sector only has 4.9 per cent of the loan portfolio of Indonesian banks (BI 2010c). From the perspective of the conventional banks, the growing operations of the Islamic banks in the microbanking sector are seen as a threat, but the conventional banks remain confident that they can maintain their dominant positions by expanding their networks and offering a variety of products, as well as providing competitive pricing in lending, deposits and other financial services.

In line with the strong presence of the Islamic banking sector, BPRS has become an emerging microbanking provider for micro-entrepreneurs and the low-income population, in particular those who seek alternative Islamic compliant-based financing and deposit services. Soon after its inception, the BPRS sector grew moderately, however its performance dropped to the lowest level during the financial turmoil in 1998. In fact, several BPRS were bankrupt and some other units were under the supervisory program of the central bank. Following the crisis, in the last five-year period, the number and financial performance of BPRS has suggested a gradual improvement. In particular the health indicators of the main banking sector have improved, for example, asset quality, liquidity and profitability, including the emergent number of BPRS with greater total assets and the number of customers with loan and deposit accounts.

As presented in Table 6.2., total assets of BPRS have expanded progressively almost four times, as well as the amount of loans disbursed and public deposits derived from the increasing number of newly established BPRS, and the internal growth within the BPRS sector. However, further analysis reveals a downward trend of the annual growth rate of both deposits and financing (Figure 6.2a.). Apparently, the declining growth of BPRS is a direct impact of the fierce competition from more commercial banks as BUS penetrate into the BPRS segment. Therefore to maintain their growth, the BPRS sector has established cooperation with BUS and UUS through a linkage program to channel the funds to the ultimate clients; this linkage can be seen from the LDR figure that, in average, is over 100 per cent.

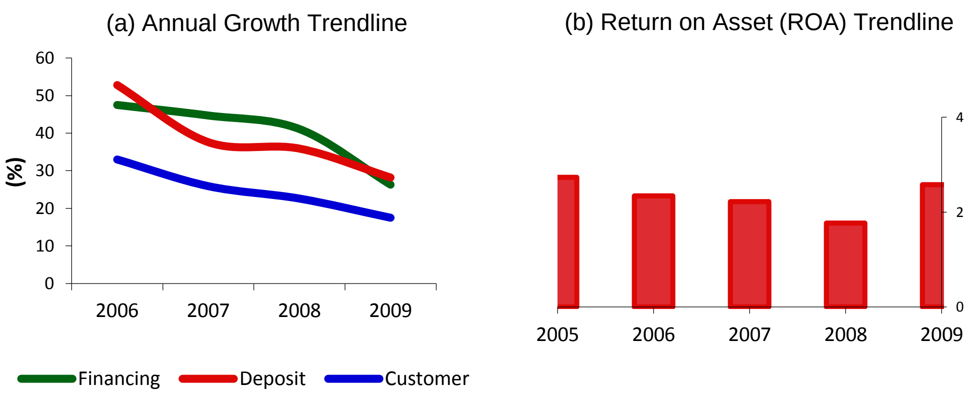
Table 6.4. Key Indicator of Islamic Microbanking Sector (BPRS)

Key indicator	2005	2006	2007	2008	2009
1. Total assets	585	896	1,216	1,693	2,125
2. Loan	417	615	890	1,256	1,586
3. NPL (%)	10.90	8.30	8.11	8.38	7.03
4. Deposit	341	521	717	975	1,250
5. LDR (%)	172	118	124	129	127
6. Profit	16	21	27	30	55
7. ROA (%)	2.73	2.34	2.22	1.77	2.58
8. Number of BPRS	92	105	114	133	139
- Assets < 5 billion	62	64	80	57	46
- Asset > 10 billion	13	19	31	40	52
9. No. accounts	268,697	357,618	450,329	552,514	649,202

Source: BI (2010c)

It means the funding source of BPRS financing is mainly supplied by BUS, UUS and borrowing from other financial institutions. Although the alliance generates funding advantages for BPRS, to some extent it significantly reduces the profitability because the cost of borrowing funds is more expensive than public deposits. Karim et al (2008) point out the underperforming profitability, i.e. ROA would affect the long-term sustainability of the sector. Concurrently high non-performing loans (NPL) also endanger the sustainability of BPRS even though there has been an improving trend in the last few years.

Figure 6.2. Trend of BPRS Performance 2005–09



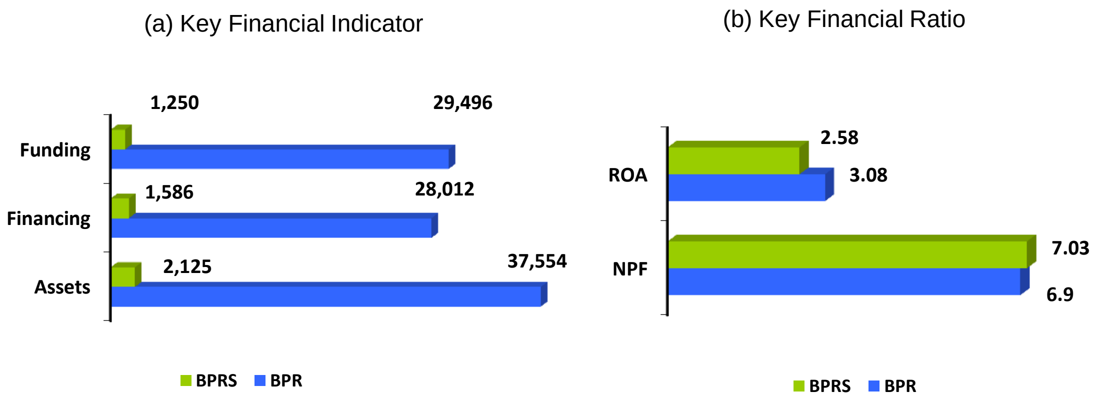
Source: BI (2010c)

Seibel (2008) identifies several constraints occurring with the development of the BPRS sector. The biggest problem is the lack of capital, which limits the expansion of the bank network and the development of the client base. Another critical deficiency is the shortage of competent human resources that are able to enhance the faith-based products and services. The study also reveals an interesting finding – that the BPRS has a more socio-religious orientation than a profit motivated orientation; this evidence clearly explains why the profitability of BPRS is less than the industrial standard. Yet the BPRS model is likely to be more favourable to poor Muslim clients, instead of focusing their energies on better-off business clients.

It is also important to note that despite the central bank providing some regulatory incentive, e.g. minimum capital requirement, it has not been effective in accelerating the establishment of new banks in the strong Muslim-based provinces outside the Java region. The possible answer for this is that the complexity of the Islamic banking system has been seen as a foremost disincentive by the investors.

Practically speaking, the modus operandi of BPRS requires improved human resources who possess specific banking skills and a solid knowledge of Islamic teachings. Yet, since it is still a young model, the awareness of Muslim societies regarding BPRS and its concepts of financial transactions is still marginal, therefore it will take considerable effort and operational costs for BPRS to achieve the massive outreach it desires, as well as to compete with the well-established BPR. In the eyes of the banking business, BPRS is less attractive compared to the conventional BPR sector.

Figure 6.3. Performance Comparison between BPRS and BPR (2009)



Source: BI (2010c

A comparative analysis shows that the BPRS sector accounted for 3.2 per cent of BUS and UUS, and posted 5.6 per cent of the BPR total assets respectively (Figure 6.3). This fact was not surprising; as a young microbanking model, BPRS has been adapting to the banking industry and positioning itself in the market and with its Muslim customers.

Compared to the BPR counterpart[66] which has been in existence for over century, the performance of the BPRS sector has visibly underperformed in many respects, including the number of outlets, total assets, funding and loans, asset quality and profitability.

6.5. Islamic Pawnshops and other Islamic Financial Institutions

Other than the Islamic banking system, the Islamic pawn system has been a growing sector as well. As mentioned in Chapter 5, the government-owned pawnshop (Perum Pegadaian) has been a pioneer of the unconventional collateral-based financing system (*Gadai Syariah*). Wasis Jauhar (Business Director Perum Pegadaian) states that the

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[66] The total number of BPR in 2009 was 1733 units, with total asset composition comprises 46 units of less than IDR 1 billion, 429 units between IDR 1 billion and 5 billion, 479 units between IDR 5 billion and 10 billion, and 779 units above IDR 10 billion (BI 2010c).

initiation of the Islamic pawn in 2003 through a partnership with BMI (the PLS contract). In this alliance, Perum Pegadaian acts as the operator by establishing the business model, offices and controlling the whole operation, whilst BMI shares some of the working capital loan through declining financing method (interviewed on 25 May 2009).

Perum Pegadaian has developed the faith-based pawn operation to strengthen its role in providing financial services for Moslems consumers who favour non-interest based transactions, and to explore a new opportunity business as well. It is similar to its generic pawn model, but the service is classified into eight categories that are based on the amount of money lent to the client: the minimum loan is IDR 20 thousand (type A) and the maximum is for IDR 200 million (type H). Each type of loan has a different service fee from IDR 1000 for type A, up to IDR 60,000 for type H) for every 10-day period of the pawn. Technically, the object of the pawn is a moveable asset, for instance, gold, jewellery, a vehicle, a household appliance, electronics, a garment, equipment or other valuable item, but in practice, the most acceptable collaterals are gold, jewellery and vehicles (Perum Pegadaian 2009).

Table 6.5. Composition of Islamic pawn through Perum Pegadaian

Classification	**Cumulative (IDR Billion)**	**Outstanding (IDR Billion)**	**Client**	**Share (%)**	**Note (Amount of pawn)**
Type A, B, C	125,513	31,769	-	21.2	IDR <1 million
Type D	285,268	74,070	-	48.2	IDR 1–5 million
Type E	104,435	25,379	-	17.6	IDR 5–10 million
Type F, G	73,748	17,300	-	12.5	IDR 10–50 million
Type H	3,037	712	-	0.5	>IDR 50 million
Total	591,704	149,217	321,577	100.0	

Source: Perum Pegadaian (2007)

Table 6.4. shows that up to 2006, Perum Pegadaian owns approximately 44 of the Islamic pawn units in 13 major provincial cities. The outlets are mainly placed in regions with a strong Muslim tradition and a saving culture based on gold jewellery. The general performance of the Islamic pawn operation suggests sound and healthy development since its inception, as the annual growth of the pawn business is outstanding and the number of customers has increased substantially, as well as the

profitability of the business. The majority of pawn services were between IDR 500,000 and IDR 10,000,000 (Perum Pegadaian 2007).

The conventional pawnshop holds a monopoly concession from the government, but in addition, in the Islamic pawnshop sector the Islamic banks and the Islamic microfinance institutions (BMT) are allowed to provide a pawn service. Generally speaking, the Islamic banks have been involved in pawnshops through the PLS alliance, i.e. BMI and Perum Pegadaian, or they establish their own business units. For instance, BSM, BMS, BRIS and some UUS and BPRS have developed a pawn product by adopting the Perum Pegadaian model. Interestingly, the majority of the banks employ former Perum Pegadaian personnel to operate their pawnshop division.

The motivation of the banks to become involved in pawnshops is because it is a lucrative market and there is huge demand for faster and simpler financing products either for business or for emergency purposes (Maulidia 2003). Just recently, there has been a sharp increase of the international gold price, and around the same time, a number of leading Islamic banks have modified their gold-based pawn service into a hybrid investment scheme which is a combination of a pawn service and a future sale contract (*Istinah* financing model). With competitive advantages in funding and more flexibility than Perum Pegadaian, the Islamic bank sector is preferable to the affluent and high-profile customers; it is not aimed at the un-bankable and low-income segments.

Nevertheless, the current practice of the Islamic pawnshop has been modified from the traditional model during the era of the Prophet Muhammad where the pawn transaction was similar to providing collateral against debt, hence there should not be any additional charge on top of the debt (Maulidia 2003). In contrast, the contemporary Islamic pawnshop system allows the financiers to obtain an extra payment for the provision of the custodian service.

6.6. Role of the Islamic Bank in Mobilising ZIS Fund

It has been discussed in Chapter 2 that the ultimate objective of the Islamic banking and finance system is to improve the socio-welfare of the Muslim population and the entire society, therefore the role of this sector should be to promote inclusive economic development, more particularly to eliminate inequality and poverty. In practice, the Islamic banks are mandated by law to perform particular socio-religious duties, for instances to pay *Zakah* from its annual profit and mobilise charitable funds from the society (ZIS), as well as to allocate the funds to eliminate poverty and other purposes.

The Islamic banking sector is involved in socio-religious programs in many ways; the common practice is inherent within the framework of the corporate social responsibility (CSR) program that was adopted from the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standard (Choudhury and Harahap 2009). Traditionally, the Islamic banks mobilise charitable funds from internal and external sources that comprise ZIS funds from corporations and employees, clients and other public philanthropic resources. Another important source is penalty and non-permissible incomes (such as income from interest-based transactions).

The ZIS donation is allocated based on the sources of the funds. For the *Zakah* fund, it is strictly allocated to eight recipients, while other funds are disbursed to various social, religious and economic programs including mosque buildings, scholarship, natural disaster recovery relief, and benevolent loans. There is no particular consensus among the banks about how to allocate the non-*Zakah* funds and who the beneficiaries should be (see further discussion in Chapter 2).

BMI, for example, set up Baitul Maal Muamalat (BMM) to manage its CSR program. In addition to allocating the *Zakah* fund, BMM supports several community-based projects, such as the KUM3 programs to finance rural microenterprises and to support the establishment of BMT in corporation with PINBUK and local Islamic organisations. Another bank, BMS, integrates its socio-religious mission into its parent company's CSR program (the CT foundation). The allocation of ZIS funds is predominantly channelled by collaboration between LAZIS and BASNAS, and the bank's philanthropic activities.

Table 6.6. Charitable Activities of Selected Islamic Banks

Bank/institution	**ZIS fund**	**Allocation**	**Note**
1. BSM	28,456	6,189	Direct (its own foundation); indirect through other LAS
2. BMI	7,125	7,125	Direct (its own foundation)
3. BMS	4,022	1,292	Direct (its own foundation); indirect through other LAS
4. DD Foundation	52,846	38,508	Direct to the end beneficiaries

Sources: Financial statement 2009 of BSM, BMI, BMS and DD Foundation
Note: The ZIS fund of the banks was a cumulative amount including penalties and non-*Halal* incomes; the ZIS funds of the DD foundation was a cumulative amount including *Waqaf* and the initial balance of IDR 16,682 million.

6.7. Future Development of the Islamic Banking Sector

The Islamic banking sector is an infant industry that naturally faces enormous challenges to develop within a massive interest-based banking and finance economy. However, after the banking reform and the economic crisis, the state of development of the Islamic banking and finance industry has gradually suggested promising trends and significant growth.

In general, the future prospects of the Islamic banking sector can be seen from three perspectives. First, viewed from the point of view of government interest and monetary stability, the adoption of the Islamic banking system would provide advantages to the whole financial system and the economic development of the country. Under a dual banking approach, the central bank would be more flexible in managing systemic risk, because the two banking models are able to complement each other. Also, as the Islamic banking concept is characterised by specific features, if there is a case of banking failure and financial crisis in the conventional banking sector, the Islamic bank can provide an alternative means to stabilise the banking and financial system; and vice versa. In this respect, the roles of the government and the central bank are critically important to set conducive interventions in order to create an enabling environment, with an equivalent regulatory framework and treatment under Indonesia banking architecture and the global financial inclusion initiative. In other words, the monetary and banking policies should be established using an integral approach including macroeconomic stability, a supportive regulatory system, and capacity building.

The second perspective is that of the customers. A serial study by the central bank (Bank Indonesia) across the Java island reveals a strong interest by Muslims in Islamic banking and a related financial system. The study's findings show a substantial number of respondents believe that charging interest is *Riba*; Islamic teachings prohibits any kind of unlawful transaction (BI 2004). In addition, the majority of respondents consider that the profit and loss sharing mechanism would bring more benefits to banks and clients, and to the economic system as a whole. Another study in the Bogor regency which has a majority Islamic population across the communities, also suggests a similar finding – that the majority of respondents are aware of the *Riba* status of charging interest, and perceive the Islamic banking approach is a safe deposit-taking institution due to the fact that the model is based on religious teachings (Muhamad and Omar 2009). There is an enormous demand for the microenterprise sector; low-income and affluent segments can be serviced by the banks as long as they are able to employ comprehensive strategies in particular to attract Muslim clients. The strategies should include product and service innovation, pricing, convenience (i.e. process and procedure), accessibility (of offices and other virtual outlets), transparency, and suitable marketing and promotion demonstrating that the Islamic bank system is not merely a religious matter, but that it provides economic advantages to the society as a whole.

Finally, from the banking perspective, it is evident that the Islamic banking business model has shown positive growth and sustainable profitability. The salient characteristics of Islamic banking, such as the PLS methodology, provides a better financial return than the interest-based loan schemes as long as risk mitigation processes are managed adequately, especially to address moral hazard especially misused of fund by the borrower. A further advantage is the recent government regulation that establishes the same tax treatment for both conventional and Islamic banking (i.e. a single tax approach on mark-up financing transactions). Other policy incentives, such as lower capital requirements and the integration of Islamic banking services within the established branches and outlets, have enhanced the competitiveness of the Islamic banking sector. Just recently, the Minister of Religious Affair introduced a policy toward ONH that the pilgrim fund must be managed under the Islamic banking and finance system. In effect, the policy would provide a source of more liquidity and business opportunities for Islamic banks.

6.8. Summary

The historical development of Islamic banking in Indonesia has been driven and strongly influenced by the political attitudes and policy decisions of the government. The first Islamic bank was established in 1992 and subsequently it was followed by the establishment of Islamic microbanking (BPRSs) and Islamic microfinance institutions (BMTs). Another cornerstone of the Islamic bank and microfinance system occurred after the financial crisis of 1998 and the collapse of the repressive government. The new reformist government reformed the banking system, which provided the legal framework for the Islamic banking sector to grow. From a different perspective, in the view of Muslim intellectuals, the establishment of the Islamic banks and Islamic microfinance institutions has been part of a renaissance of Islamic values and activism after many years under the repressive regime of the New Order Government.

The Islamic banking and microfinance sector has advanced steadily in terms of the number of institutions, business volume and outreach, however its market share remains relatively small and it has not been a leader, although the majority of the population is Muslim. Under the dual banking system, it seems that the faith-based banking sector has quite a difficult task to compete with its conventional counterpart which has dominated the market. To some extent, the Islamic banks are the subsidiary of conventional banks, therefore the strategy of Islamic banks are influenced by the parent banks. In addition, the Islamic banking sector faces limited access toward Islamic-based money market instruments in order to increase their capital and liquidity, including being hampered by a shortage of capable human resources.

In the future, the sector shows indications for positive development and prospects since a great number of new Islamic banks and Islamic microfinance institutions will be established along those lines, with growing awareness and understanding of Muslims toward a non-interest-based banking system, and the supportive policy of the government and the central bank. Chapter 7 will review the BMT sector and discuss its initiation and development inherently in line with its Islamic banking counterpart.

CHAPTER 7

THE BMT SECTOR AT A GLANCE

The BMT sector has been significantly influenced by the development of the Islamic banking sector and the revival of the Islamic socio-political movement. The creation of the BMT system was inspired by the idealistic notion to improve the socioeconomic conditions of the majority Muslim population. More importantly, the operation of the Islamic banks and Islamic microfinance programs, especially BMT, has opened up greater access to grassroots communities (Arifin 1999).

With political support from the government, BMT programs have been introduced in several provinces across Java. This chapter discusses the background and motivation behind the creation of the BMT system and its historical development. Furthermore, it assesses the performance of the BMT sector and its position in the Islamic banking and finance landscape. In order to provide a better understanding of the sector, the networks between the BMT sector, Islamic organisations, Islamic banking institutions, and other financial institutions are outlined.

7.1. The Inception of the BMT System

The origins of the Islamic microfinance model were initiated in 1980 by an Islamic student association of the Bandung Institute of Technology that established the Baitul Tamwil Teknosa (BTT), operating under the cooperative system. It seemed this initiative was primarily inspired by Islamic teachings regarding *Riba* – prohibition of interest – and the creation of Islamic banks in the Middle East and Malaysia. Although the BTT operated with a cooperative license, it was not a genuine cooperative. In fact, the license was actually used as an alternative strategy to establish an Islamic financial institution. Since the BTT was mainly driven by socio-religious motives, it was not run on a financially sustainable basis and quickly developed a large portfolio of non-performing loans and ran out of capital (Antonio 2004).

A few years later, in 1988, a group of Islamic activists established another form of non-interest loan and saving cooperative under the name Koperasi Ridho Gusti (KRG). The establishment of KRG was motivated by the success story of the Grameen Bank's microfinance program in Bangladesh. Its operations were financially and technically supported by the central bank through a linkage program between the bank and NGOs (PHBK).

KRG's operations adopted the Islamic-based profit and loss sharing mechanism (PLS), however for political reasons, the founder of KRG explicitly argued that the PLS system was appropriate for PHBK's objective to alleviate poverty (see further discussion in Chapter 5). Compared to an interest-based loan, the KRG system would not create an excessive burden on the members when the loans defaulted, and, more importantly, it helped eliminate the moneylender practices in the informal microfinance market. In addition, the KRG's use of the PLS model was motivated by Islamic teachings against *Riba*. Aries Mufti notes that, similar to the case of its predecessor (BTT), the management of KRG failed to sustain the operations when funding support from the PHBK program was terminated (interviewed on 13 August 2008).

After the first Islamic bank (BMI) was shown to be a successfully operation, the government saw the BMT model as an alternative poverty alleviation tool that could be integrated into the national development plan, and President Suharto launched the BMT system on 7 December 1995 (Aziz 2005). The BMT system was based on the experience of the BTT, KRG and BIK, and was also influenced by the genuine spirit of the cooperative movement as reflected in the Indonesian constitution (UUD 1945) and longstanding microfinance practices developed since the colonial era. Equally important, the system was inspired by the success of the Mit Ghamr community-based Islamic bank in Egypt in early 1960[67] (El-Naggar 2006) and the Grameen Bank group-based microcredit model and gender-oriented poverty alleviation and empowerment programs in Bangladesh (Yunus and Jolis 1998). It is apparent that the BMT system was not a new Islamic microfinance model, rather one that evolved from the practices and experiences of different countries.

Historically, as briefly mentioned in Chapter 6, the creation the BMT system has been a collective effort of the Indonesian Islamic Council (MUI), the Indonesian Islamic

[67] Mit Ghamr Bank is recognised as the first Islamic bank in a Muslim country. It was established in 1963 by an Egyptian scholar, Ahmed A. El Nagger in the city of Mit Ghamr near the Nile delta. The bank used a local saving and credit model and built close mutual relationships and trust between bank personnel and its clients (El-Naggar 2006).

Intellectual Association (ICMI) and BMI.[68] According to Aslichan (Executive Director of PINBUK), in order to support the BMT institutions, in 1996 Professor Muhammad Amin Aziz, a prominent Islamic scholar and member of the Board of ICMI, as well as a prominent Muhammadiyah figure, established the Center of Small Business Incubation (PINBUK) that provided assistance and capacity building to the BMT sector (interviewed 2 May 2009). Although PINBUK plays a central role in the BMT movement, it is also important to acknowledge the contribution of the Dompet Duafa foundation (DD) and the Study Center and Development of Small Businesses (Pusat Pendidikan dan Pengembangan Usaha Kecil or P3UK) in the development of the BMT system.

DD introduced the Islamic economy and the BMT concept to a group of young Islamic activists, and provided seed capital to support the BMT institutions. This program gained strong backing from B.J. Habibie, the Minister of Research and Technology and Chairman of ICMI. Hence in 1995 he formally announced the establishment of 10 BMT institutions, several of which were located in the DIY province (see detailed discussion in Chapter 8).

Similar to the BMI, the socio-religious mission behind the creation of the BMT system is mainly to provide non-interest microfinance services that are allowed by the Islamic teachings and suitable for Muslims (Effendy 2003). More specifically, the creation of the BMT system reflected the great concern of many Islamic leaders about excessive and predatory loan practices of moneylenders. It was widely known that these informal finance providers take advantage of low-income and poor people through short-term loans with very high interest rates that, in turn, lead the borrowers into over-indebtedness problems, with the result that they become even poorer.

In addition, the BMTs sought to support the government programs to provide non-*Riba* financial services to microenterprises in the informal sector that are beyond the outreach of the commercial banking network and the government microfinance programs. The

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[68] According to Aries Mufti (the Chairman of ABSINDO), ICMI and BMI established a partnership to strengthen poverty reduction efforts and improve the welfare of poor Muslims through income-generation activities. Accordingly, a working group was set up and led by Professor Muhammad Amin Azis. The main purpose of the task force was to design a model of microfinance under the Islamic finance principle, but its operation would be simpler than an Islamic bank, however it would be able to reach the grass roots of Muslim communities (interviewed on 13 August 2008).

ICMI leaders recognised that the policies to support the microenterprises and SME sectors through subsidised microfinance programs – like agricultural credit, village cooperative programs and SME loan schemes – had successfully broadened access to financial services for rural communities. However, the programs were not appropriate to serve the Muslim population since all these programs were based on the conventional interest-based loan system. In other words, the ICMI leaders sought to establish an alternative microfinance system.

An equally important aspect is that the BMT system is aimed to support the government's poverty alleviation policy by integrating the socio-religious philanthropic program into the microfinance approach, especially to help destitute households. Thus the BMT system is set up to perform as a charitable institution (LAZIS) by simultaneously collecting, managing and distributing charity funds directly to the needy, including for emergency relief, economically productive activity and other socio-religious purposes. The BMTs would function as an Islamic charity organisation with a community-based membership.[69]

7.2. Islamic Microfinance Development

Since its inception, the BMT sector has developed significantly in terms of the number of institutions and their geographical outreach. However, it is quite difficult to obtain accurate nationwide statistics for this sector (Adnan et al. 2003). Several databases provide only a partial picture and this is understandable, because the majority of BMT institutions operate in local communities, beyond the view of the MENEGKOP-UKM as the central authority. It is also worthwhile to note that no comprehensive study has been conducted to collect reliable data about this sector and determine how the majority of BMT institutions operate in communities (Sakai and Marijan 2008).

Aziz (2004) provides a general overview, and records that about 2938 BMT institutions operated across the provinces in 2001. In a more detailed analysis, Sakai and Marijan (2008) classified the BMT institutions into three categories:

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[69] It is common in Muslim communities that most charity programs are organized by the mosque and local Islamic organisations. Charitable collections are usually conducted during daily and weekly prayers, and during the month of Ramadan.

- BMT with assets below IDR 50 million accounted for 9.3 per cent of the BMT;
- assets between IDR 50 million – IDR 500 million comprised 78.8 per cent; and
- those with assets above IDR 1 billion made up 4.8 per cent.

The most recent figures from PINBUK suggest an increasing number of BMT institutions – up to 3200 units in 2006 – and a further estimation states that every year there would be between 1000 and 2000 new BMT institutions established, serving an estimated 10 million client members (Amalia 2009).

Table 7.1. Development of BMT Sector

Phase	**Year**	**Number of BMT**
Initial growth	1990–95	300
Rapid growth promoted by PINBUK	1996 1997 1998	700 1,501 2,470
Slowing-down of growth	2000	2,938
Stagnation and decline period	2001 2003	3,037 2,856

Source: Seibel (2008)

The major proportion of the BMT institutions is located in Java, mainly in the cities, townships and villages of central Java and the DIY provinces. There are only a small number scattered elsewhere in Java and in the other provinces (Sakai and Marijan 2008). A study conducted by Seibel (2008) reveals that the outreach of the BMT sector at the national level is insignificant and the overall performance difficult to examine due to lack of regulatory and supervisory mechanisms, and a comprehensive reporting system.

Based on data from the BMT Center, the BMT network demonstrated progressive growth in total assets as well as in deposit volume and loans outstanding in the 2005–08 period (see Table 7.2.). In 2008 the growth of financing was slightly above the deposits such that the ratio of loans to deposits (LDR) was over 109 per cent. On average, each BMT institution manages IDR 6.7 billion in total assets, mobilised IDR 5.2 billion deposits and disbursed a IDR 5.7 billion loan portfolio (PBMT 2009).

Table 7.2. Key Financial Indicators of Selected BMT Institutions

	2005	2006	2007	2008
1. Asset (IDR million)	363.7	458.4	660.1	931.7
2. Deposit (IDR million)	209.0	357.8	462.4	725.7
3. Loan (IDR million)	264.6	320.6	436.7	792.5
4. Number BMT (unit)	117	120	130	138

Source: PBMT (2009)
Note: The figure only represents the BMT institutions under the BMT Center membership.

As a local community-based financier, the BMTs serve a significant number of client members, of whom the majority are un-bankable and beyond the market of the formal banking sector. In addition, the vast majority of the BMT institutions' clients are traders and microenterprises in the service sector (PBMT 2009). From this perspective, it seems that most of the BMT loan portfolio supports productive economic and income-generation activities, which are critically important in poverty alleviation and empowerment programs (see further discussion in Chapter 8 and 9).

7.3. Position of the BMT Sector within the Islamic Banking and Finance Industry

The BMT sector is not an exclusive financial system, although its position in the banking and financial sector is classified as a semiformal microfinance provider.[70] However, from the economic development perspective, some scholars (Antonio 2004; Amalia 2009; Sakai 2008), argue that the BMT sector has played an outstanding roles in fostering the dynamic growth of the informal and microenterprise sectors and the household-based economy in the regions where formal banks do not exist. Thus, the BMTs fill a niche segment, which is perceived to be high-risk and unprofitable by commercial bankers.[71]

[70] Semiformal microfinance is not linked directly with the monetary system and also it is not under the control of the central bank (see Chapter V).

[71] The perception has changed, as many commercial banks (both conventional and Islamic) have entered the microbanking and microfinance markets.

As the BMT sector grows significantly, it has attracted the banking sector and the government – including international agencies – to establish an alliance that integrates the BMTs with the formal banking and financial institutions. Historically, the initial collaboration between the Islamic banks and the BMT sector was led by the BMI; subsequently it was formalised by the central bank in 2005, which expanded the linkage program between Islamic banks and the BMTs in several ways. It has gradually grown in terms of funding and financing volumes as well as by the number of banks and the BMT institutions involved in the program.[72]

Antonio (2004) identifies several models of linkages, including equity participation, deposit placement, syndicated financing, loan channelling and credit extension. Furthermore, he argues that the linkages generate several advantages for the BUS and BMT sectors as well as for the government.

1. The linkages are a means for the BMT sector to access more liquidity from either commercial or concession funds and break down the chronic liquidity problem and also increase the financing capacity of the BMT sector to serve more clients.
2. For the banking sector the linkage model is a commercially viable financing scheme for the BMT institutions, quite similar to other types of commercial lending since it is based on market mechanisms. It is also more cost-efficient rather than direct financing to microenterprises.
3. The linkage program is politically beneficial for the government, as through this mechanism concession funds for the microenterprise sector can be allocated into productive economic and income-generating activities which ultimately works to alleviate poverty, unemployment and other socio-economic problems.
4. For the central bank the linkage approach is a strategy to improve financial intermediary activity through increasing the loan to deposit ratio (LDR), broadening financial access to un-bankable borrowers and evening out the money flow from one region to another, from rural areas to urban areas and vice versa.

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[72] Bank Indonesia developed a linkage program to support the BPR's liquidity performance by encouraging commercial banks to extend loans to the BPR institutions. The first phase of the linkage project had great success since many commercial banks and BPR were involved in the program. Accordingly, the program has been expanded to reach the microfinance institutions, including the linkage program between Islamic banks (BUS/UUS) and the BMT sector.

In addition to the above linkage programs, there are a number of government-owned financial institutions, including PNM and LPDB, which have financed the BMT sector. As mentioned in Chapter V, PNM has been involved in the linkage system by channelling the concession government funds (SUP-005) to the microfinance sector (BPR/BPRS, KSP and BMT).

Sunarto (2007) points out that PNM channels government funds of nearly IDR 205 billion at subsidised interest rates based on Bank Indonesia's certificate rate (SBI). In return for this role, PNM receives a 4 per cent fixed margin, making the final interest rate charged to the microfinance institutions approximately 11 per cent. Thus the BMT institutions should return the SUP-005 fund equivalent to 11 per cent as well. Subsequently, the microfinance institutions must disburse the funds into microcredit schemes to support productive activities at a maximum interest rate of 20 per cent per annum, which is significantly below the average of commercial microcredit interest rate that is above 30 per cent per annum.

In contrast to the PNM linkage program model, the LPDB channels the *Sharia* revolving funds from the MENEGKOP-UKM budget (DBS-KUKM). The fund was originally established in 2004 by the government in order to strengthen the liquidity and financing capacity of nearly 100 BMTs. Since 2005, the DBS fund has been managed by LPDB. It is based on the profit and risk sharing principle, with a proportion of 60–80 per cent of the loan margin retained by the BMT institutions (equivalent to the commercial microcredit interest rate) and the rest (equivalent to the 3-month SBI's interest rate or an average of 6 per cent) should be returned to LPDB to support the operation of the institution.

The mechanism of the LPDB linkage model is channelled through secondary cooperatives or apex institutions such as INKOPSYAH and PUSKOPSYAH. Accordingly, the apex cooperatives disburse the loans to their BMT institution members and finally to the client members. It seems that this model is more complex and riskier compared to the other linkage programs, since LPDB has no direct relationship with the BMT institution partners and lacks control of how the funds are used by the BMT institutions. Instead, LPDB relies upon the apex institutions to oversee the fund and the performance of the BMT institutions.

In general, the linkage programs conducted by the PNM and LPDB institutions have enhanced the growth of the BMT sector, however the expansion of these linkage programs has been constrained by the limited networks of both the PNM and LPDB. To some extent the institutions also faced the risk of moral hazard, i.e. loan default because of the misunderstanding of some sections of the public that the funds were the government's money and did not need to be repaid.

7.4. Affiliation of the BMT Sector with Other Organisations

Initially, the BMT system enjoyed strong political support from the New Order regime, however, Sakai (2008) argues that the current stage of BMT development is not dependent on government support; it is substantially influenced and driven by influential Muslim scholars, clerics and entrepreneurs, Islamic organisations and NGOs. These organisations provide seed capital, capacity building, training and moral support. In the next section the supporting roles of PINBUK, Dompet Dhuafaa foundation (DD), PT. Permodalan BMT (PBMT), ABSINDO and Apex BMT will be discussed.

7.4.1. PINBUK

According to Aslichan (Executive Director of PINBUK), the organisation was established in 1996 to develop the BMT system in collaboration with the MUI, BMI and ICMI. Legally, it is a non-government organisation (NGO) and an autonomous agency although its operations were supported by the government and several leading Islamic organisations (interviewed 2 May 2009). The primary role of PINBUK was capacity building by providing consulting, technical assistance and training programs for start-up BMT institutions. PINBUK played a central role in the creation the BMT system and the establishment of thousands of BMT institutions across the provinces, mainly linked to government projects. For example, in 2004 PINBUK, in cooperation with the Ministry of Social Affairs, developed nearly 87 BMT-KUBE in 19 provinces.

The PINBUK role was mainly to provide training to local facilitators, the BMT-KUBE managers and staff and the BMT committee members. In addition, PINBUK was responsible for overseeing the BMT operations and for assisting the management and committee members to transform the BMT-KUBE into fully licensed KJKS, and to become independent and self-sufficient BMT institutions. Since PINBUK has a strong relationship with the government programs, this organisation is regarded as an arm of the government's administration to license and oversee the BMT sector.[73]

7.4.2. Dompet Dhuafa Foundation

The Dompet Dhuafa foundation (DD) has been involved in the BMT movement since 1995.[74] The foundation initiated the establishment of nearly 60 BMT institutions by allocating seed capital and providing technical assistance. Through this support DD sought to alleviate poverty and empower the lives of Muslims because the BMT approach can perform multiple roles in economic and socio-religious empowerment. More importantly, the operations of BMT are permissible under Islamic principles, as well as being commercially viable and able to sustain its operation in the communities. The BMT institutions were also representatives of the foundation and a vehicle to expand its charitable programs across the provinces (Sudewo 1995).

To initiate the BMT project, DD and P3UK (the Study Center and Development of Small Business) carried out training programs for start-up BMT institutions in Central Java, West Java and DIY provinces. In addition, DD allocated significant funds to support the initial capital and provide basic infrastructures for newly established BMT institutions. The success of the DD's BMT institutions won great appreciation from the Muslim intellectuals, including the chairman of ICMI (see detailed discussion in Chapter 8). DD then established the BMT Center, a capacity building organisation that provided training and technical assistance for its BMT network in order to replace the function of P3UK. In 2007, the foundation, in association with leading BMT institutions, established a venture capitalist institution – Permodalan BMT (PBMT) – as a vehicle to mobilise commercial funds from the Islamic banking sector and private investors in order to support the emerging BMT institutions (PBMT 2009).

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[73] PINBUK registered the 'BMT' label under its copyright. The objective of this copyright is to prevent misused of the BMT brand by any party who used the system for their own and/or personal interest, i.e. mobilising funds from the communities for fraudulence motives.

[74] Initially DD was named the Dompet Duafaa Republika when it was founded on 2 July 1993 as a branch of the *Republika* daily newspaper affiliated to ICMI. The institution was formed by journalists concerned about their socio-religious obligations following the food shortages in the Gunung Kidul district of the DIY province. In short, the Republika Brotherhood Association was founded to collect *Zakat* and *Infaq* from the journalists and employees of *Republika* as well as to mobilise charity funds from readers for donations to the Gunung Kidul districts (see detailed discussion in Chapter 8). The association was officially transformed to the Dompet Dhuafa Republika foundation on 14 September 1994. Furthermore, on 10 October 2001, DD has been approved by the Ministry of Religion as an independent ZIS institution (DD 2013)

7.4.3. Permodalan BMT

Permodalan BMT (PBMT) is a venture capital organisation that is majority owned by DDF and the BMT institutions under the BMT Center network. Saat Suharto (Director of PBMT) states that the underlying motive for the establishment of PBMT is driven by the commitment of DD to continue supporting the BMT Center and its BMT institutions, but this did not distract them from the main mission of DD as a ZIS organisation[75] (interviewed on 25 April 2009).

The BMT Center is an umbrella organisation for hundreds of BMT institutions across the provinces which require substantial funding for expanding their emerging businesses, however as locally-based microfinance institutions, these BMTs have a limited capacity to mobilise large deposits from their members. In this respect, PBMT is a venture capitalist institution able to deal with the funding shortage. In general, PBMT has been able to mobilise commercial funds from private investors as well as accessing lending schemes from BUS/UUS. Its financing capacity has increased significantly, and gradually it has become a major source of funding to the members of its BMT network.

7.4.4. ABSINDO

According to Aries Muftie (the Chairman of ABSINDO, interviewed on 13 August 2008), the National Association of BMTs was established in 2005. ABSINDO focuses on advocating the BMT sector through its mission through the following three goals:

1. to empower the BMT sector, in particular to support the MSE sector development,
2. to enhance coordination and collaboration among the BMT institutions, and
3. to initiate the establishment of a national apex institution and a BMT guarantee system.

In 2009 ABSINDO introduced a pilot project of a BMT liquidity network by integrating BMT institutions into an online system and introducing BMT cash to provide more varied services to client members. Practically speaking, however, ABSINDO faces the difficulty of not having sufficient skilled staff and funding support to promote the

[75] In 2005, the founder of PBMT sought advice from the author to find the best solution for DD and the BMT Center. My suggestion was that DD should establish a venture capitalist instead of a social foundation so that the PBMT could mobilise private and commercial funds, thus it would sustain the long-term operations as well as produce a profit.

programs to the public and members of the association, hence many BMT institutions are not aware of ABSINDO's activities and lack interest to join the association.

7.4.5 Apex BMT

INKOPSYAH (Induk Koperasi Syariah) or PNM-BMT is an apex institution of the BMT sector. This institution was established in 1998 under the secondary KJKS license and operates at the national level (INKOPSYAH 2009). The initiative was driven by PINBUK and nine leading BMT institutions with a primary mission to provide funding support to the members and the BMT sector. In the beginning, however, INKOPSYAH was not effective in addressing the funding constrains of its members because its sources of internal funding (seed capital, compulsory saving and membership contribution) were very limited. In 2002, INKOPSYAH was capitalised by PNM through an IDR 2 billion equity participation and IDR 5 billion linkage program loan; since then INKOPYSAH has been under the control of PNM and has changed its name to PNM-BMT. Currently PNM-BMT has 225 BMT institutions and PUSKOPSYAH (sub-apex cooperative institution) as members. PNM-BMT has also been able to access funding from the Islamic banking sector (BUS/UUS) and LPDB linkage program.

7.4.6. Other Islamic organisations

More generally, the development of the BMT sector has also been influenced by several Islamic organisations. One of the prominent supporters has been Muhammadiyah, the leading modernist Muslim organisation, which has a vast membership across the country (see further discussion in Chapter 8). Muhammadiyah embraces the BMT system as a strategy to empower its members and the broader community through both direct involvement and indirect support. The first approach was through establishing a BMT institution under its own name – Baitul Tamwil Muhammadiyah (BTM) – which operates as an Islamic loan and saving cooperative; the socio-religious functions (*Baitul Maal*) are undertaken by the Baitul Maal Muhammadiyah (BMM).

One of the objectives is to support the BMTs owned and managed by Muhammadiyah members or affiliated community-based foundations. In this approach, the organisation provides support and access to the organisation's funding resources, in particular by placing deposits and encouraging its members to save in the BMT institution. Sakai (2008) notes that Muhammadiyah adopts the BMT system because it is well-suited in the organisation's vision and mission, whereby, since its inception, Muhammadiyah has employed socio-economic means in addition to spiritual motivation.

7.5. Summary

The BMT system is influenced by the historical development of the Islamic banking sector, which dynamically progressed in line with the change in political attitudes of the New Order regime. Nevertheless, the ICMI scholars and modernist clerics agree that the BMT system is a suitable means to implement Islamic values as well as to alleviate poverty and empower Muslim livelihood under the national development strategy (Azis 2005).

As a community-based means of microfinance, the BMT sector faces huge challenges in its development and lack of attention from the government compared to the other government microfinance programs. However, regardless of its drawback as a local-based and semiformal institution, the BMT sector has played a major role in providing financial access to un-bankable and Muslim inhabitants who favour alternative financial services. Although the status of the BMT system is that of a semi-formal microfinance provider, its position within the banking and microfinance sector is increasingly important since there are growing linkage programs between the BMT sector and Islamic banks and other financial institutions (PNM and LPDB). In addition, it is apparent that BMTs have established a strong association with the leading Islamic organisations and other community institutions.

In the next chapter, the discussion will specifically address the operations, position and roles of the BMT sector in DIY province.

CHAPTER 8

THE DYNAMIC PRESENCE OF BMT IN YOGYAKARTA

The BMT system was introduced in the Yogyakarta region at the beginning of its development in 1995. Initially there were BMT institutions officially operating in Yogakarta city, Sleman and Bantul sub-districts. The first model of BMTs inspired many Islamic leaders and intellectuals to support the BMT movement. The BMT system has flourished to provide Islamic microfinance services to Muslim communities. For this reason this study has specifically selected the BMT sector in Yogyakarta as a case study.

This chapter discusses several issues related to the main research questions, in particular seeking to understand why and how the BMT system was developed in Javanese Muslim society and to assess what factors influence how the faith-based microfinance system works in this socioeconomic environment. The discussion in this chapter is descriptive and analytical, based on the information collected during field research, including accounts from direct observation and documentation from the BMTs and government agencies.

The chapter has three sections. Section one explores the pattern of BMT development from when it was established until 2011. The analysis examines the key personnel and supporters, and the motivation behind the BMT movement. The general features of the BMT institutions, in particular their institutional characteristics, legal and supervisory models, governance principles, management structures, human and resources profiles, and membership systems, are assessed as these aspects influence the operation of BMTs over the long term. The final section examines how the BMTs have performed their socio-religious mission (*Baitul Maal*) in line with their microfinance service.

8.1. BMT Movement in Yogyakarta

Revisiting the introduction of the BMT system in Yogyakarta, there was a nexus of religious sentiment and socioeconomic motivation that drove the BMT movement. Initially, the establishment of the pioneer BMTs was the idea of several Muslim elites in Jakarta, who then involved prominent local Muslim scholars and clerics in the movement. The following discussion elaborates on the historical background and recent development of the BMT system as a faith-based microfinance institution.

8.1.1. Motivation and Mission

The BMT movement began when the Dompet Dhuafa foundation (DD) became involved in supporting a group of Muslim student activists – Corp Dakwah Pedesaan (CDP) – to preach Islamic religious teachings (*Dakwah*) in remote villages. The aim of the CDP program was to reach out to poor communities, especially to counter the presence of Christian missionary and philanthropic activities in the less-developed villages of the Gunung Kidul district.[76]

Initially, according to Erie Sudewo (the co-founder and the first Chairman of DD, interviewed 14 May 2009), the primary motivation of the foundation of BMT movement in Yogyakarta was to draw Muslims' attention to the Christian religious missionary activity. He points out that at that time, many Islamic intellectuals and clerics were concerned about the missionary strategy and philanthropic programs that were silently implemented a religious agenda to expand Christian religious teachings in Muslim communities. He emphasised that the Christian missionary programs could not be countered solely by the generic CDP activities. Instead, to address the real problems of ordinary Muslims, there should be an integrated solution including the provision of anti-poverty programs. In response to this need, DD introduced the BMT system into the Islamic preaching agenda and shifted the nature of the CDP modus operandi to be a more comprehensive poverty alleviation program. It was hoped that by the integration of the BMT system into the CDP program, it could perform a dual function. The presence of BMTs not only enhances the religious devotion and help the needy, but it also empowers them by providing loans to run microenterprises, be economically self-reliant and have social self-esteem.

The approach of DD seems similar to other practices of faith-based microfinance, for instances in India, Pakistan and other countries (Harper et al. 2008). Integrated microfinance enables communities to improve the basic livelihood of their residents and

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[76] Yogyakarta is a tolerant society where many religious beliefs exist in harmony (see Chapter 4). It is known as a strong centre for Muhammadiyah (one of the leading Islamic organisations) but there is also a strong presence of Christian churches that are active in assisting poor people in the villages. Many local Muslim clerics perceive the philanthropic programs of the churches as a means to influence destitute Muslims with Christian beliefs, so they called it a *Kristenisasi* program.

alleviate chronic poverty. Equally, it is an effective medium for religious teachings to increase spiritual devotion in order to counter the influences of non-Islamic faiths.

Second, in line with the above sentiment, the finding reveals that the *raison d'être* of the BMT movement is to provide non-*Riba* microfinance service for Muslims (FGD, 20 August 2009 in Yogyakarta). Despite the fact that at that time there was no formal religious jurisprudence from the Islamic council (*Fatwa* MUI) regarding the interpretation of interest rate as *Riba*, intellectual Muslims and clerics had given much thought to the issues of interest rates and conventional banking from the perspective of Islamic economics. However, as the Islamic microfinance system was a new model, they were inclined to express a moderate view by accepting that faith-based finance could operate in parallel with conventionally based microfinance. This pragmatic approach seems similar to the findings of the study in West Java (Prawiranata 2013).

At this time, the movement wanted to demonstrate that the BMT system, with its distinctive modus operandi, could challenge the presence of excessive informal microfinance providers, especially moneylenders in the region surrounding Yogyakarta, as well as in other regions.

Moneylenders are the most common community-based microfinance practice and they have been part of the fabric of small communities since the 19th century, if not before. The findings of the study reveal that the presence of moneylenders in the community occurs with different modus operandi, and they operate on a very mobile basis to serve their clients. Initially it seems that moneylenders are very effective in providing financial services for the un-bankable segment of the community, however the loans are provided at very high interest rates and take advantage of poor households, who in most cases, have become trapped into over-indebtedness and become even poorer (Ghate et al. 1992). However, from the perspective of Islamic doctrine, any form of economic and financial exploitation is unjust and is strongly prohibited. The majority of Muslims support the worthy objective of eliminating moneylenders from the local economic system.[77]

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[77] By law, moneylending and usury are illegal, hence any provider could be subjected to the criminal code.

Nur Affifah (founder of a pioneer BMT institution) states that her motivation was mainly driven by spiritual consciousness to counter the socioeconomic problems in her village. More specifically, she emphasises her principal objective was to eliminate the excessive practices of moneylenders and other predatory lending schemes conducted by informal microfinance institutions (interviewed on 20 June 2009). Apparently her view is shared by many supporters of the BMTs who sought to liberate traders in the village markets and poor villagers from the debt trap created by loan sharks. The BMT movement provides legitimacy and encouragement to campaign against the illicit moneylenders.

Another important religious mission of the BMT movement is to alleviate poverty. Amin Aziz, a patron of the BMT movement, states that the BMT framework is designed to deal with the complex nature of poverty (Aziz 2004) since the BMT institutional structure comprises a mixture of faith-based microfinance (*Baitul Tamwil*) and a charitable institution (*Baitul Maal*). Erie Sudewo notes that the modus operandi of the BMT institutions is to address obstacles in the local economy, such as the lack of access to microfinance services. The *Baitul Maal*, as a philanthropic mission, can function to collect alms (ZIS) and distribute the funds to the needy and destitute inhabitants in the villages. The role of the BMTs is to strengthen the government programs working to alleviate poverty[78] (interviewed on 14 May 2009).

The Muslim elites explicitly positioned the BMT movement to complement the government programs in enhancing the microfinance sector. According to Syahbenol Harahap, former Director of the Multi Service Department of MENEGKOP-UKM and the Chairman of the Yogyakarta Chapter of the Indonesia Cooperative Council (DEKOPIN), the government accepted the movement because the BMTs were critically important as an alternative microfinance service to serve poor households and

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[78] Besides providing the social security services and community development programs, for example PNPM-MANDIRI, the government encourages voluntary philanthropy that allows civil society organisations and individuals to participate in poverty alleviation programs. For example, the government established a semi-autonomous agency (*Badan Amil Zakat Nasional* or BAZNAS) to mobilise ZIS funds, as well as to manage and distribute the ZIS funds to disadvantaged people, including for emergency relief, economic productive activities and other socio-religious activities.

microenterprises that are beyond the outreach of the government's anti-poverty and microfinance program[79] (see also Chapter 5).

In addition, he notes that the distinctive features of the BMT seem suitable for the un-bankable segment of the population in order to escape from the exploitative loans of moneylenders, and for the Muslim entrepreneurs who understand the teachings of *Riba* (interviewed on 2 June 2010).

It is also important to note that the perspective of the intellectuals and pious Muslims has significantly shifted to accept that the BMT roles are not only to provide faith-based microfinance institutions but that it could also carry out a religious mission to address the complex social and economic problems in Muslim societies. In this way, the BMT movement is also part of an 'Islamisation of Muslims' process.[80]

The BMT system is a multi-pronged response to this process:

1. The BMT system is a response to the debate about *Riba*, the payment of interest, and to a National Islamic Council *Fatwa*[81] (*Fatwa* MUI).
2. The modus operandi of the BMT system is the realisation of Islamic economic practices, as asserted by Ridwan (founder of BMT Bina Insanul Fikri), that the objective of BMTs is to enhance the welfare of the members and the whole community (interviewed, 12 June 2009).
3. The BMT system is a means by which members can perform spiritual duties (*Dakwah Muamalah*).[82]

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[79] It is widely known that the top-down policies of the state through the subsidised microfinance programs, for examples the agricultural credit (BIMAS and KUT), the village cooperative program (KUD), the SME loan schemes (KIK-KMKP), the sub-district credit institution (BKK), the village bank (BKD), the loan and saving cooperative (KSP/USP), and the other rural credit and saving institutions (LPD, LDKP, TPSP), failed to provide sustainable financial access for the rural communities and the microenterprises.

[80] Muslim Javanese society comprises several different segments. Clifford Geertz defines Javanese Islam into three categories: *priyayi*, *santri* and *abangan* (see Geertz 1960). Hyung-Jun Kim identifies two segments: traditionalist and modernist (see Kim 1996).

[81] There is a dualism in the views of the majority of Muslims toward conventional banking and finance. One opinion states that the interest rate of commercial banks and microfinance is not *Riba* because it is not excessive, as is the case with moneylenders. Another notion is that the conventional bank and microfinance is permissible under emergency situations (*Darurah*), because there is no Islamic banking and microfinance services available.

[82] *Muamalah* literally means Islamic teachingss to guide how Muslims should conduct interrelationships among themselves and other parties in socioeconomic affairs such as financial transactions, trade and commerce etc. *Dakwah Muamalah* is similar to the strategy of Muhammadiyah that uses its hospital and clinic networks to influence the traditional-syncretism belief, i.e. witch-doctors (see Nakamura 1983).

Azis (2004) states that the vision of the BMT system is a movement (*Jihad*) to bring prosperity (*Arrahman*) and to strengthen brotherhood among Muslims (*Ukhuwah*). It is thus a pathway to build an autonomous Muslim society (*Madani*), strong in spiritual devotion and socioeconomic development.

8.1.2. Founders and Supporters

Literally the inception of the BMTs in Yogyakarta was a collective effort of three particular supporters such as DD, Muhammadiyah and the local ICMI members. In this regard, the ICMI members, in particular the architects of the BMT system, who are also active followers of Muhammadiyah, played a significant role in the early period of the BMT movement. In addition, Erie Sudewo notes that endorsement from the Sultan was critically important to ensure the implementation of the BMT system in the local communities (interviewed on 14/05/2009).

Yogyakarta is a centre of the Muhammadiyah movement. In general, Muhammadiyah leaders view the fundamental values behind the BMT movement as very similar to the mission of their own organisation, in particular to improve the livelihood and spiritual devotion of followers and the majority of Muslims. [83] Interestingly, however, Muhammadiyah has no official relationship with the BMT movement; instead, influential Muhammadiyah intellectuals and clerics are involved in the BMTs.

As mentioned by Ridwan, (a member of Pemuda Muhammadiyah DIY and a founder of the pioneer BMT institution), the Muhammadiyah, although not directly involved, had a critical informal role in supporting the BMT movement, in particular during the early period (interview on 12 June 2009). Mardiono, the founder of BMT Mitra Usaha Umat in Yogyakarta, acknowledges the role of his colleagues in Muhammadiyah as co-founders and providers of the initial capital. They also encouraged followers (*Jamaah*) of Muhammadiyah in the sub-district to join the BMT as members (interviewed on 18 June 2009).

At the community level, the contributions of local spiritual leaders (*Kyai*) have been enormous, and they are also very important advocates to promote the survival of the BMT movement and to change people's religious belief toward the non-interest

[83] The Muhammadiyah movement began in 1912; see Nakamura (1983) and Alfian (1989).

microfinance system. Mursida Rambe, the founder of BMT Beringharjo, mentions the assistance of the clerics who provided space and furniture for the BMT office in the Beringharjo mosque (interviewed on 4 June 2009).

The clerics are, of course, associated with Islamic boarding schools (*Pesantren*), mosques and religious groups (*Kelompok Pengajian*). With their leadership position in the societies, the clerics are in a position to influence the Muslims' perception about *Riba* and the payment of interest, and to convince people that the BMT system is an ideal economic instrument to promote prosperity under the framework of Islam. In a paternalistic society like Javanese villages, the cleric (*Kyai*) is the central spiritual leader. The position is regarded as honourable and trustworthy because the cleric has knowledge and understanding of Islamic teachings (the Qur'an and the *Haditst* of the Prophet Muhammad). In Javanese village communities, the eminent clerics are role models for their followers and many have encouraged their followers to join the BMTs as founders, managers, members and investors.

Similar to the previous study by Sakai (2008), the founders of the BMTs in Yogyakarta were typically committed intellectual Muslims who have a religious consciousness and are socially concerned about the socioeconomic problems – especially poverty and economic disparity – in their surrounding communities. They are mostly well-educated activists and affluent Muslims, who live in an urban middle-class society and have sufficient knowledge about the Islamic financial and economic system and other matters related to Islamic teachings (Hadiz and Teik 2011).

In general the BMT founders (mainly scholars, clerics and young Muslim activists) can be categorised into conservative and progressive camps. The conservative Muslims tend to emphasise the authentic nature of *Sharia*-compliant microfinance and want the BMTs to focus on their social mission. The progressives are inclined to be more pragmatic and maintain flexibility in the mission and operations, with the objective of ensuring the financial sustainability of the BMTs (see also discussion in Section 8.1.3). According to Edy Nofianto, (Executive Director of PUSKOPSYAH DIY), although there were different values and priorities among the founders of the BMTs, there was little public debate and there was a consensus that the BMTs could perform both the religious and the socioeconomic role in the community (interviewed on 10 June 2009).

It is also worth noting the symbolic role and support of the Sultan from the origin of the BMT movement in Yogyakarta.[84] Firstly, as the charismatic Sultan and Muslim, the Sri Sultan is an important figure to raise people's awareness of the BMT system. The BMT activists acknowledge that the Sri Sultan has provided great moral support and contributed significantly to the BMT movement. Secondly, his support as the DIY governor is demonstrated through the government's policy to incorporate the BMT system into the official anti-poverty programs.

According to Koesdarto (the Head of DISPERINDAGKOP-DIY), the Sri Sultan has been impressed by the comprehensiveness of the BMT concept. Although the DIY government has a limited budget, he strongly endorses the district administration's policy to allocate funds to support the initial capital and technical assistance for the establishment of new BMT institutions in the areas of chronic poverty and less developed villages (interviewed on 11 June 2009). In some districts the BMT sector has flourished and the number of BMT institutions has experienced significantly growth.

The local patrons of the BMTs play important roles in accepting leadership positions from Jakarta-based figures as the BMT concept is implemented in the Yogyakarta community. They provide continuing support to the transformation and development of the BMTs as a faith-based microfinance institution.

8.1.3. Transformation of the BMT Movement

The development of the BMT sector in the region is quite similar to the pattern of the Islamic banking sector (Antonio 2004; Juaro 2008). It experienced slow growth during its infancy, and then increasingly developed after the economic crisis in 1998. In the early stages, the movement faced obstacles that restricted the development of the BMTs, mainly a lack of government support, limited capital and skilled personnel, divided Muslim opinions about *Riba* and pessimistic views of the non-interest-based microfinance system.

At the outset, the BMT movement was backed up by the government, however the support was purely a political accommodation of the President Suharto to respond to the

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[84] The Sri Sultan held the grand opening of the the BMT Berignharjo head office – one of the pioneer BMT institutions and the biggest in the DIY province – on 19 July 2008 (Mursida Rambe, founder of BMT Beringharjo, interviewed on 4 June 2009).

growing influence of the Muslim intellectuals (Antonio 2004). The BMTs are owned and managed by local communities hence the government assistance with funding and technical support was minimal and, if any, it was not sufficient to foster growth of the BMT sector. Mursida Rambe related that in the early years, nearly all the pioneer BMT institutions encountered enormous constraints to develop fully operational capacity because of lack of capital and shortage of skilled personnel to manage the new faith-based financial institutions (interviewed on 4 June 2009).

Moreover, Totok Suparwoto (founder of BMT Mitra Usaha Insani and MCI group) asserts that during its infancy the BMT movement received little attention from the government therefore only a few BMT institutions could sustain their operation, and several others experienced slow growth and finally were closed down[85] (interviewed on 15 June 2009). Instead, the surviving BMT institutions relied mainly on support via internal resources such as the founders, members and the local Muhammadiyah organisation.

However, the political situation dramatically changed in the Reformation era,[86] when the BMT movement started to gain new momentum through formal recognition from the government and growing support from Muslim societies. Syahbenol Harahap suggests that the new government's view toward the BMT movement was very positive. The BMT model was integrated into the cooperative sector and allocated significant government budget to provide a revolving credit scheme for the existing BMT institutions, and new BMT institutions were established under government programs (interviewed on 2 June 2010).

Moreover, following the political transition period (the era of decentralised government and democratisation),[87] the BMT sector has progressed rapidly, especially in the

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85 Before and during the economic crisis (1995–2000), there were approximately 21 BMT institutions registered in the region surrounding Yogyakarta City.

86 President Soeharto was replaced by Vice-President B.J. Habibie (who at the time was also the Chairman of ICMI). In general, the new government eliminated political discrimination and restrictions that provided a profound opportunity for the revival of the Islamic movement in politics and the socioeconomic sphere. Another important event for the BMT movement was when the President appointed Adi Sasono (the General Secretary of ICMI and a proponent of the BMT movement) as the Ministry of Cooperative and SME (MENEGKOP-UKM).

87 After the general election in 1999, Abdul Rahman Wahid (the Chairman of the Nadathul Ulama, an influential Islamic organisation) was elected President. In 2000, the presidential post was handled over to the Vice-President, Megawati Soekarno Putra. In this era, the BMT sector development was driven by the active involvement of the local district administration and also influenced by the emerging growth of the Islamic

suburban areas where a great number of new BMTs have been established. This phenomenon has encouraged the involvement of the local district governments. In the last few years, the BMT movement has emerged and become a popular source of Islamic microfinance. The following analysis demonstrates some interesting critical factors and contextual issues that influenced the development and transformation of BMTs:

1. The BMT movement was influenced by the revival of Islamic organisations across the country. As previously mentioned, in the local community in Yogyakarta, the majority of BMTs were associated with the prominent religious intellectuals and clerics, and they played a variety of roles in the BMT movement, mainly as the founding fathers, fund-raisers, on the boards of management and as members as well. Equally important, these local religious circles are also member of the Islamic organisations and the community-based group of Muslims that have direct access to several apex Islamic organisations in Jakarta, for examples ICMI and Muhammadiyah. Thus this network was a great advantage to the movement as it provided political networks, moral support and, more importantly, access to government program funds.
2. In accordance with political advantage, there was also a positive shift toward the faith-based microfinance system. In the beginning, the *Riba* interpretation was a matter of debate among Muslims, hence there was much scepticism concerning the BMT system and its modus operandi. According to Priyongo Suseno, the introduction of the BMT system, with non-interest-based financial transactions was not well-responded to by the majority of grassroots Muslims in the local communities (*Islam Abangan*), because they considered that the different features of BMT products were more complicated than conventional microfinance (interviewed on 10 July 2009). After several years of operation, the pioneer BMTs could sustain their businesses, therefore their success inspired the expansion of the BMT model across the region.

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banking sector across the regions in the island of Java. In 2008, during the term of President Susilo Bambang Yudhoyono, the government enacted the Islamic Banking Law as a legal foundation for the Islamic banking system, however the law excludes the BMT system in the national banking landscape (see further discussion in Chapter 7).

3. The features of the BMT system are well suited to the economic structure of the DIY province, which is largely occupied by the informal economy, microenterprises and the SME sector. The large number of microenterprises, petty trading, crafts, self-employment and farming, generated a huge demand for microloans and saving that can be served by BMTs; in particular they became attractive to the un-bankable segments and Muslim clients who were comfortable with the non-interest financial transactions
4. The BMT movement has had a gradual transformation from an organisation founded on idealistic socio-religious motivations into one with a more economic orientation and pragmatic microfinance practices. As stated in the previous section, BMTs operated in the dual banking system, which is dominated by the conventional system. For this reason, BMTs are likely to embrace a pragmatic strategy rather than a normative-rhetoric approach by adopting simple products that are likely to be similar to those offered by conventional microfinance institutions, and are suitable for the needs of the majority of people. In addition, BMTs established relations with the conventional banks without damaging their own reputation and their Islamic values.[88]
5. Finally, the BMT sector, in one way or another, has embraced commercial practice in order to sustain operations and to reach out to a wide variety of market segments. Naturally, the socio-oriented microfinance program should be transformed into a more profit-oriented model when it becomes better established (Helms 2006). The BMT cases demonstrate similar pattern that maximise its return by embracing the commercial practices, through partnership with private investors and obtaining commercial loans from Islamic banks.

In summary, the study identified three pathways of BMT development:

- Model 1: BMTs are transformed into a charitable religious institution (*Baitul Maal*). This model is predominantly associated with mosques and Islamic philanthropic organisations; it channels benevolent loans to the destitute and the poorest, for example the MISKAT program of the Daarul Tauhid Foundation.

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[88] The presence of the Islamic bank networks is very limited, hence many BMT institutions use the conventional banking branches to perform financial transactions, including the deposit of excess funds, remittance, and in emergency situations (liquidity shortage), the BMT borrows funds from the conventional banks.

- Model 2: The generic BMT concept, by a combination of economic (*Baitul Tamwil*) and social (*Baitul Maal*) missions. This is the most common type of BMT; it provides commercial microfinance and also conducts charitable programs.
- Model 3: A pure economic-centric microfinance institution (*Baitul Tamwil*); its organisational arrangement and modus operandi is designed to focus on financial brokering and generating maximum profit for the investors and owners.

8.2. General Attributes of BMT Institutions

This section examines the intrinsic characteristics of BMTs that are highly influenced by religious teachings. The analysis focuses on aspects such as general organisational style, management and human resources, modus operandi, products and services that determine the BMT institutions' sustainability and success as models of an Islamic community-based form of microfinance.

8.2.1. Organisational Structure

The BMT structure encompasses *Baitul Tamwil* and *Baitul Maal*. The *Baitul Tamwil* is designed to conduct financial intermediations by mobilising saving and deposits from member clients and allocating the funds to finance commercial ventures. The *Baitul Maal*, however conducts socio-religious activities by collecting charitable donations from the community to support poverty alleviation programs and enhance the spiritual devotion of Muslims. In other words, the BMT system combines economic and socio-religious objectives that operate under Islamic financial principles.

The core principle of the BMT system is that it is community-based and the institution is established, owned and governed by the members to achieve the collective objectives of the members. It is also an independent unit, as every member shares equal obligations and responsibilities, including the right to express opinions, vote and serve as a member of the supervisory board of management. As mentioned in the previous discussion, technically, the BMT adopts the cooperative principles of loans and saving. It also embraces the socio-religious Islamic values of solidarity and brotherhood among Muslims and other elements of society (*Ukhuwah Islamiah*).[89]

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[89] *Ukhuwah Islamiah* is an Arabic term that means 'to maintain a relationship among the Muslim brotherhood'.

Table 8.1. Distinctive Attributes of BMTs

Baitul Tamwil	***Baitul Maal***
Mobilise savings and deposits from members	Mobilise charitable funds from communities
Allocate the funds to finance profitable businesses run by the members	Distribute funds to particular beneficiaries
Provide other financial product and services	Organise socio-religious programs
Profit oriented	Non-profit oriented
Objectives – to improve the economic welfare of members and community, and to generate sustainable returns to founders/investors	Objectives – to alleviate poverty, empower and enhance the religious lives of poor people and the whole community

Source: Adapted from Azis (2004); findings from field research in 2009.

As a community-based institution, a BMT institution is quite flexible, simple and typically requires a modest amount of seed capital. The establishment process is similar to that for generic cooperatives and so it comprises several stages and administrative procedures. It begins with the establishment by a group of 20 to 40 prominent people in a community, including informal Muslim leaders, entrepreneurs, teachers and other influential people.

At this initial stage, commitment and the roles of the founders are very critical because they determine the degree of success of the BMT establishment. They have the responsibility of maintaining the following procedures until the BMT is ready to take over its operations.

- The first task is to source the initial capital and donations from Islamic organisations, mosques and other philanthropists; a minimum amount of approximately IDR 20–35 million would be required in an urban community, and IDR 10–20 million in a rural area.[90]

[90] The initial capital of BMT consists of compulsory saving (*Simpanan Pokok*/SP) which is mobilised from the founders; the amount is established based on mutual agreement; the SP is similar to a share and each founder can contribute as much as possible but the amount of SP will not increase the voting power as the BMT grants each member just one vote. In addition to SP, there is *Simpanan Pokok Khusus* (SPK), which is additional capital that can be mobilised from new investors in order to strengthen the capital. The investors can be regarded as founders with approval from the majority of the initial founders (see also discussion in Chapter 9).

- The founders should define a set of agreed principles;[91] the vision, mission and objectives of the proposed BMT institution, including the formulation of basic operation manuals and standard procedures (SOP).
- An organisational structure needs to be formed that consists of a management board, a supervisory board, *Sharia* compliance board and manager. In many cases the founders also recommend the board of management to recruit the main operational staff including a marketing officer, a teller and a book keeper.
- An office building needs to be provided, along with supporting infrastructure, equipment and other essential office supplies.
- Finally, the founders should seek endorsement from the village administration and/or other local authorities; this endorsement is necessary when the BMT applies for a formal license to the MENEGKOP-UKM.

In addition, the founders play an important role in promoting the newly established BMT and supporting the management in attracting new client members, especially depositors, because, in many cases, the prestige of this person and the reputation of the founders would insure the confidence and trust of the community.

The BMT organisational structure is quite simple but it embraces a modern organisational concept, which reveals a clear division between governance, management and operational functions. The central event of a BMT institution is the Annual General Meeting (AGM) that is held once a year, no later than April. At the AGM, all members and/or representatives of membership (in some cases the number of members is more than 100) are invited to discuss the performance of the board and management, the achievements and business plan for the forthcoming year. Usually at this meeting several critical decisions are made, principally the approval of the annual financial report, disbursement of dividends and the election of management and supervisory board members (see Figure 8.1).

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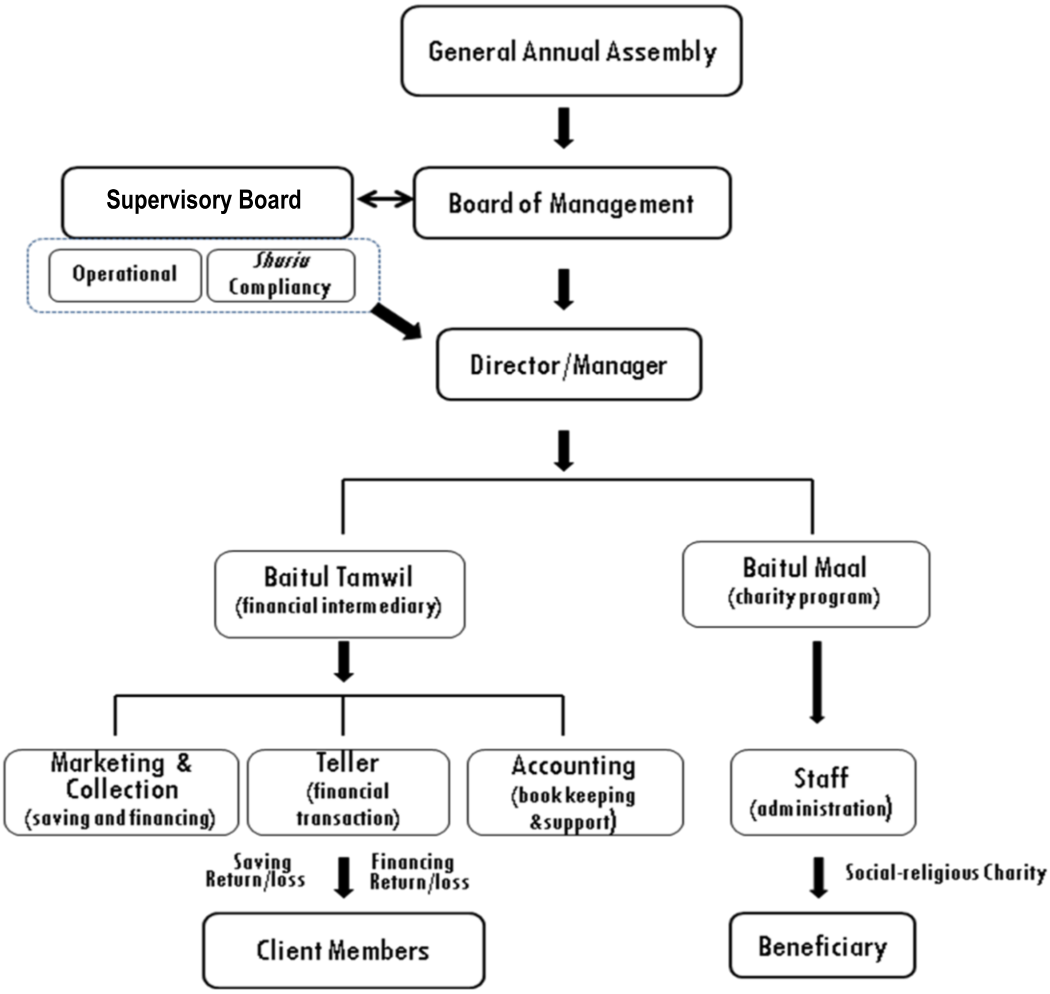
[91] The BMT institution must have a principle accord that comprises be established in accordance with *Anggaran Dasar* (AD) and *Anggaran Rumah Tangga* (ART). AD is a general guidance, while ART is a set of implementing guidance principles.

Figure 8.1. Generic Business Model BMT System



Source: Azis (2004) and field research in 2010.

At the AGM, each member has equal rights and obligations in setting the common goals and objectives of the BMT, including to appoint members of the board. The decision-making process is based upon a basis of mutual sharing in that every member is encouraged to express her/his opinion and to contribute money, time and effort towards the development of the BMT. In addition, each member has equal voting rights and has the opportunity to be elected as a board member for a certain period. A person can be re-elected several times as long as she/he is appointed by the members (Azis 2005). It is common that the AGM also involves the performance of Islamic rituals such as reciting a verse from the Holy Qur'an and listening to religious lectures from a prominent cleric before the meeting is started. At the end of the AGM, the Chairman of the board leads prayers (*Du'a*) to express gratefulness and ask for blessing from God.

In addition to the AGM, there can be an extraordinary AGM (*RAT Istimewa*) conducted in response to an emergency or critical situation. The extraordinary AGM should involve the majority of the founders, the board of management and supervisors, and/or two-thirds of the members.

The BMT is governed by a board of management and overseen by a supervisory board. The board of management consists of a chairman, secretary and treasurer, who are elected from the members by the members at the AGM. The main tasks of the board are to manage, oversee and control the activities of the BMT, including the daily operations. Another primary duty of the board is to provide general direction and policy for the management to design the business plan. It also conducts regular meetings with the manager in order to review and monitor the BMT's performance. At the end of calendar year, the board should publish a management report that is presented and evaluated at the AGM.

Under the board's management, there is a manager or director who oversees day-to-day operations in compliance with the operation manual and regulations. More importantly, the manager is responsible to ensure that the BMT achieves financial sustainability and carries out charitable programs (Aziz 2005). The manager is also responsible for general policies, strategic decisions, a business plan and annual budget, human resources development (HRD) and social welfare programs, in order to sustain the BMT's performance and growth for a long-term future.

In the structure of the *Baitul Tamwil*, the manager is supported by at least three functional staff. First, marketing is a primary profit-making unit that is responsible for selling and marketing the savings and financing products. The marketing staff also carries out screening of clients, financing analysis, collection and non-performing loan management. Second, the teller's function is in charge of handling cash transactions and to attend to client members who visit the BMT office. Third, the accounting staff is responsible for bookkeeping, reporting and general administrative functions.

In the *Baitul Maal* the manager is usually supported by the accounting staff. There is usually a fixed structure of the *Baitul Maal* unit although it depends upon the complexity of the socio-religious programs and the volume of donation funds. The nature of BMT organisational structure and functions is very flexible and dynamic. Generally, the arrangement of the institution is developed according to the size of the assets, business expansion and number of members of the particular BMT. Findings from the field suggest that many BMTs have quite a complex structure and staffing structure, especially those with many branch networks and diverse business units.

There are two common methodologies of the BMT operation: PINBUK and KSP (KJKS) models. The first model is developed by PINBUK, where the BMT operation platform consists of a financial intermediary and empowerment through group formation, training and regular meeting activities. The later is adopted from the practice of the microfinance cooperatives (KSP), but the BMTs emphasise the provision of financial services to individual members based on Islamic principles.

PINBUK develops its BMT operational model based on the integrated microfinance school of thought. A typical style of BMT under PINBUK guidance and supervision is group-based empowerment, particularly in association with the government's poverty alleviation program. Aziz (2004) explains that the foundation of the PINBUK approach is group formation (POKUSMA or KUBE)[92] which encompass a number of poor people; ideally each group should consist of about 10 members. The main purpose is for these people to conduct income-generating activities such as microenterprises or self-employment and, more importantly, the members should commit to deposit compulsory savings and save regularly in voluntary saving accounts, as well as to contribute to religious alms, when applicable. All members are encouraged to attend an introduction session that briefly explains the BMT institution and its vision, mission, objectives and program.

The following step is to screen the candidates for group membership by assessing their commitment to improve their livelihood and their willingness to participate in program activities. The selected candidates will be in a group based on the similarities in their

[92] POKUSMA stands for *Kelompok Usaha Muamalat* and KUBE stand for *Kelompok Usaha Bersama*. The latter term literally means 'a collective group', and is developed under the Ministry of Social Affairs' poverty alleviation program.

businesses, or home address. Before obtaining the first financing contract all group members must pledge to be a good member, attend compulsory group training and regular group meetings.[93]

The basic curriculum for the members' training comprises a general introduction pertaining to Islamic-compliant saving and financing methodologies, and enhancement of business skills, including how to establish group and implement decisions and programs. Using the PINBUK approach, the group meeting is a crucial activity in which all group members are encouraged to engage in problem-solving discussions, business experience sharing sessions as well as listen to religious sermons (*Pengajian*), engage in religious discussion and recite the Qur'an. The group meeting is also used as a time for mobilising savings, loan disbursement and instalment collection, collecting contributions for social welfare and religious alms as well as networking in order to strengthen the social bonds and engagement among the group members.

In general the PINBUK methodology is akin to the Grameen Bank's approach, although the model does not exclusively promote women's empowerment. Its financial modus operandi is based on the Islamic microfinance system. During the early stages and soon after the establishment process, PINBUK played a vital role in establishing new BMT institutions and standardising operating procedures, providing technical assistance and overseeing the management of the institutions until the operations reached a sustainable stage (see Chapter 7).

Another style of BMT is the KSP business model, which was originally adopted from the cooperative microfinance system. In contrast to its conventional counterpart, the KSP model focuses only on the financial intermediary mechanism by collecting savings from individual members, and disbursing those funds to other individual borrowers. In this model, the membership is not based on the formation of groups, and the BMT does not conduct training and/or regular meetings. In general, any eligible individual can

[93] A compulsory training program is carried out by PINBUK staff or a community development worker. The training duration is about an hour each day for five days (a total of five hours) and all members must attend the sessions consecutively, except if there is an unforeseen event such as sickness or other urgent matters. The group meeting is a weekly meeting that held for nearly 90 minutes in a member's house and is led by a PINBUK/BMT staff member. The members should come to meetings on time, for any member who fails to achieve a minimum meeting attendance would be eliminated from the group; however, before the termination takes place, usually group members would try to persuade the undisciplined member by visiting her/his home and asking if there is a domestic problem, i.e. restriction from the husband or head of the household.

apply for membership by visiting the BMT office, filling in a membership application and making an initial compulsory deposit. Usually, the BMT approves applications instantly with very simple verification. At this stage, the BMT grants temporary membership and a pass-book saving account for recording voluntary savings. During the period of temporary membership, the client is encouraged to conduct regular transactions and increase the balance in the voluntary saving account. After fulfilling all criteria, the client is eligible to be granted permanent membership and is then entitled to full rights and obligations, including access to the financing facility if the member is considered creditworthy and complies with the terms and conditions.

The KSP model is widely adopted because the initiation process is less complicated and, more importantly, the cooperative approach has been practised for many years and is compatible with the Islamic microfinance system. Another advantage of the KSP concept is that the management is more independent and flexible in managing the BMT operation, with less interference and supervision from external parties (i.e. the government). Technically, the design of the BMT institutions have their specific features, with comparative advantages and disadvantages, as summarised in Table 8.2.

Table 8.2. Description of BMT Institution Design (PINBUK and KSP Model)

Attribute	**PINBUK Model**	**KSP Model**
Approach and microfinance school of thought	Integrated: financial intermediary and empowerment through group-based membership with training and regular group meetings.	Minimal focus on providing financial services to individual members.
Advantage	Continuous support with technical assistance and supervision to support the management. Members are trained and empowered: more discipline in saving and financing installment; better knowledge and skill in business; stronger social capital; better commitment to perform religious duties. Appropriate for poverty alleviation and empowerment program, in particular to reach poor and poorest inhabitants.	Initiation process quite simple and straightforward. Management more independent and self-reliance. Greater flexibility for members as no compulsory training and group meeting. BMT management and staff focus on business development. Appropriate for broader financial access to microenterprises and unbanked segment.
Disadvantage	Establishment stages more complicated by group formation, membership screening and pre-training, Need more effort, dedicated staff, time and cost to conduct empowerment program. Rely upon external support, e.g. government Negative image; social organisation that hampers the development of *Baitul Tamwil* (financial intermediation) performance.	Management faces more challenges during start-up phase as no support from external parties. Minimal membership screening that would create free rider and problems with misappropriation. Loose social capital and discipline among members. Less focus on *Baitul Maal* program in mobilising alms and other socio-religious activities.
Similarity	Both models adopt cooperative principles and employ the Islamic microfinance modus operandi in their financial intermediary activities (saving and financing transactions).	

Source: author compilation from field research 2009

8.2.2. Institutional Title

Unlike the conventional microfinance institutions, as the BMT system is designed to carry out a faith-based microfinance operation in the community it embraces Islamic elements in many aspects of its daily operation; one of the most distinctive features is using Arabic terminology '*Baitul Maal Wat Tamwil*' as a brand name. The study found that in Yogyakarta, the BMT institutions use a mixture of the Arabic, Indonesia and/or Javanese terminology and phrases for the organisational titles. The most common BMT name is a simple and catchy phrase that contain meanings such as prosperity, humane, trustworthy, self- sufficient, wealth, blessed, brotherhood and other faith-based words. Several examples of leading BMTs use institutional titles: BMT Beringharjo, BMT

Mitra Usaha Insani, BMT Bina Insanul Fikri, BMT Al-Ikhlas, BMT Bina Ummah, BMT Batik, BMT Dana Syariah, BMT Mentari, BMT Bangun Rakyat Sejahtera and BMT Surya Parama Artha.

According to Saat Suharto, the adoption of Arabic phrases and calligraphy within the title of BMT institute is crucial, although the term is not compulsory. In particular it demonstrates that the Islamic symbolism and religious spirit are the integral elements of the BMT system (interviewed on 4 May 2009). This notion is widely accepted by the majority of participants in the focus group discussions. They strongly agree that the adoption of Arabic terminology would differentiate the BMT from the conventional counterparts (FGD in Yogyakarta on 20 August 2009).

In a more structured discussion, several participants asserted that the government should formalise the Arabic terminology '*Baitul Maal Wat Tamwil*' rather than labelling the BMT system as '*Koperasi Jasa Keuangan Syariah*', in order to distinguish the difference.[94] However, Bambang Harimurti, the head of the Cooperatives agency of the DIY province, argues that the government fully supports the recommendation by allowing the use of the 'BMT' phrase and Arabic terminology, together with its formal title 'KJKS' and cooperative logo; in this way, the combination of terminologies would give a clear indication to people so they can distinguish between the faith-based and the conventional cooperative models (interviewed on 9 June 2009).

According to Harper et al. (2008) the religious focus is commonly used in order to demonstrate a distinctive image as a faith-based microfinance organisation, especially in the eyes of its followers. Moreover, Beaty (1999) states that in the Javanese Muslim tradition, Arabic is perceived as the language of religion, as it is used in the verses of the Qur'an, praying, congregation and other worship rituals, therefore it is believed the Arabic phrases convey a powerful Islamic imaginary that can influence the thoughts of the vast majority of traditional Muslims.[95] In Indonesia, there are numerous Arabic words that have been adopted into the national language and culture, and are also

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94 The Islamic Banking Law and the central bank regulations stipulate that an Islamic bank (BUS/USS/BPRS) has to display the word '*Sharia*' in the institution's title, and the 'IB' logo.

95 Arabic is recognised as the language of the Holy Qur'an in several verses, including QS: 11–2, 13–37, 16–103. However, Arabic is also the mother tongue of many non-Muslim peoples in the Middle East.

widely used in informal communication in the public domain, hence to some extent the use of Arabic phrases in the BMT institutional title would not be a handicap.

According to Fealy (2008), in the contemporary society, the presentation of religious language and symbolism has been understood beyond the routine ritual activities; it has also been a central point in the phenomenon of religious commodification and in the Islamic revival movement. Faith-based features have become a very popular business strategy and widely used across the domestic economy, including in the Islamic banking and microfinance sector. Interestingly, a similar phenomenon has also occurred in other Islamic countries, i.e. Malaysia where a faith-based financial industry has been progressively developed (Ernst & Young 2013).

Arabic terminology is not only applied to the institutional brand but it is also adopted for product names. Although there are no restrictions on the use of Indonesian or Javanese terms, it was found that nearly all the BMTs used Arabic phrases in the names of their loan and saving products as well as in financial contracts. In this respect, the BMTs follow the product codification of Islamic banking as formulated by the central bank. Based on observations and casual discussions with informants, however, the general impression of the BMT client members – who are mostly traditional Javanese Muslims – suggests that the use of the Arabic terms for the names of the BMT products is possibly a less important feature, because the terminology is often confusing, as the borrowers do not really understand the meaning of the Islamic words. Instead, they are more concerned about the benefits and services that are offered by the BMTs. This suggests that many of the Muslim borrowers are interested in the faith-based financial products because of the attractive returns and features of services that offered by the Islamic banks, rather than the religious values associated with Islamic banks (Fealy 2008).

Nevertheless, it seems that the impact of the Islamic symbolism is quite significant in its influence on the general public perception, awareness and recognition of Muslims toward BMT. Casual discussions with non-BMT members suggest that they have heard about BMT, and they simply understand it as an Islamic financial institution (*Lembaga Keuangan Sharia*) that provides loans to low-income people and micro-businesses. However, when they are asked a specific question about the modus operandi of BMT, many of them do not understand the terminology used for the products and services.

Overall, though, the growing presence of BMT is widely accepted by Muslim communities regardless of their social and religious status.

8.2.3. BMT Institutional Culture

As discussed earlier, the main basis of the BMT movement is to enhance Islamic spirituality. In this context, the movement should not be viewed only as an economic facility, but should be also be viewed by a comprehensive perspective of how it helps to implement Islamic values as well as rebuilding prosper Islamic society (*Masyarakat Madani*).

For the BMT supporters and activists who are mostly reformist Muslims, it is important to understand the normative and religious symbolism within the value and culture of the institution. Interviews and discussions with the informants, including the founders and boards of management of BMTs, have shown that there have been growing concerns to ensure that Islamic dogma is carried forward into real actions that should be conducted by all involved, in the daily operations of the BMT, including the management and staff.

According to Asli Chan, the Executive Director of PINBUK, the main objective of the BMT movement is to realise God's orders in the Qur'an, and to ensure that the teachings and lifestyle of the Prophet are transformed into Islamic values (interviewed on 12 May 2009). He believes that Islam is a comprehensive religion and must be translated into the broad dimensions of Muslims' lives. He mentions a statement of his mentor, Amin Azis, about the importance of the BMT entities to maintain religious consciousness and to behave as devoted Muslims (Aziz 2004). In this context, the spritual value of the BMT system is similar to the concept: 'Islamise everyday life that is, to behave in Islamic ways and to perceive things in an Islamic framework … encompasses all domains of human life: from ways of praying, fasting and almsgiving to ways of seeking wealth, trading and banking' (Kim 1996, p. 83)

Saat Suharto (interviewed on 4 May 2009) confirms that the interpretation of the religious teachings is embraced in the five core beliefs of the BMT movement:

- ultimate happiness (*Falah*),
- perseverance and patience (*Mujahadah*),
- teamwork and brotherhood (*Jamaah*),

- innovative and continuous improvement (*Islah*), and
- to serve for the best (*Ibadah*).

Similarly, Totok Suparwoto also argues that the BMT model should institutionalise the practice of the Prophet as a successful and admirable businessman, as He always maintained qualities of professional conduct (*Fatonah*), communication (*Tabligh*), trustworthiness (*Amanah*) and honesty (*Sidiq*).

In broader terms, Ninawati (a member of the Board of Supervisors of BMT Beringharjo) states that Islamic ethics is the foremost aspect of BMT, hence both the management and employees should demonstrate a culture of honesty and courteous behaviour, particularly in building relationships with clients and the society in general (interviewed on 4 June 2009). Murisda Rambe points out that in BMT institutional culture there is an obligation for female staff to dress in conservative Islamic clothing, and to control their appearance and manner when in public (interviewed on 4 June 2009). In other words, within the BMT institution there is a rule that everyone should be responsible to create and maintain a harmonious and religious environment (*Suasana Agamis*).

In order to realise the above norms and values, the majority of BMTs conduct various ritual activities. The most common is to perform regular morning prayers (*Doa Bersama*) before office hours asking for blessings and guidance from God, as well as religious sermons on a weekly and/or a monthly basis. These activities mainly involve reciting the Al-Qur'an verses (*Pengajian*) and discussing various spiritual topics, for example, the relationship between God and humans (*Hablumminalah*), the Five Pillars of Islam (*Rukun Islam*), interpersonal relationships (*Hablumminanas*), the Islamic socio-economic system (*Muamalah*), and other current topics that are of relevance to the community. The regular spiritual gathering is also aimed to build a strong moral foundation and self-awareness about how to be a good Muslim and, more specifically, to understand the responsibility of each person's involvement in the BMT movement.

Other BMTs conduct their internal programs to enrich the spiritual devotion of management and employees. For example, the BMT Beringharjo and the BMT BIF organise a weekly activity, usually on Friday morning, by inviting clerics to discuss a wide range of problems and their solutions under Islamic teachings. Several other

BMTs under the MCI network frequently conduct an annual retreat that is designed to improve morality and integrity, trustworthiness, honesty and the leadership skills of the staff, as well as to tighten internal bonds and teamwork under the perspective of Islam. In general, the purpose of the program is to develop an Islamic entrepreneurial approach in the BMT culture.

As the objective of the BMT movement is driven by the idea of ‘Islamisation’ of Muslims, it is apparent that the BMTs have demonstrated a distinctive religious image, symbolism and institutional culture, which have been internalised as spiritual capital and a strong foundation of the daily operations of BMTs. In parallel to the case of the BMT, in recent years spirituality enhancement has also been an emerging phenomenon in the banking and financial sector generally. In this respect, the religious values and rituals are seen as a complementary approach to increase the performance of personnel in addition to other technical training programs. It is hoped that moral and spiritual enhancement is a means to prevent misconduct and fraudulent behaviour[96].

8.2.4. The Legal Status of the BMT system

The BMT system can be viewed as both a semiformal and an informal microfinance sector. The semiformal aspect is a subject of the Cooperative Act No. 25/1992, with its operational methodology regulated by MENEGKOP-UKM decrees. In the later case it is unclear which government agencies are responsible, but to provide a simple explanation, the majority of informal BMT institutions, i.e. BMT-KSM, are under the supervision of several government agencies as they are part of the government’s antipoverty and empowerment programs, including PHBK, while others are not regulated by the government.[97] This study focuses on regulated BMT institutions that have a legal status, supervisory and governance system.

It is commonly understood that the legal basis of BMTs is the Islamic cooperative microfinance (KJKS/UJKS) system, which is regulated by the Cooperative Law and the

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96 A good example is how religious values have been introduced at the Bank Rakyat Indonesia (BRI). Although BRI is a conventional bank, religious activities of a number of religions are regularly conducted. The bank also conducts spiritual training programs as part of its monitoring and audit strategy to combat fraud across the branch offices and the BRI micro banking units.

97 There is a misunderstanding that PINBUK is a licensed and supervised non-cooperative BMT institution or self-help group (BMT-KSM). In fact, BMT-KSM is under the domain of the Ministry of Social Affairs, and several other institutions are under the Ministry of Internal Affairs or Ministry of Local Government. There is a grey area and overlap in functions among the government organisations.

MENEGKOP-UKM regulations through Decree No: 91/Kep/M.KUM/IX/2004 and its amendment, No. 35.2/PER/M.KUM/X/2007.[98] Formally, the government considers and regulates the BMTs as cooperatives, and the term 'BMT' is not specifically mentioned in government decrees and regulations, however, in practice, the BMT label and KJKS/UJKS are interchangeable. In practice, the government allows the use of the BMT label but the institution must be incorporated as a KJKS/UJKS, and use the cooperative symbol and cooperative licenses accordingly.

In the past, the cooperative sector including BMT was controlled by the central government. However, since the era of autonomy, the central government's role and control have been transferred to the provincial and district governments. In effect, the licensing and supervision process of the cooperatives have been restructured in line with the government hierarchy and territorial coverage. Based on the new government system, MENEGKOP-UKM is responsible at the national level, and the provincial and district administrations are in charge of the regional and local BMTs, respectively. In addition, the MENEGKOP-UKM and the local government administrations are responsible for monitoring and supervising the overall cooperative sector. They would also be responsible for liquidating the institution if there were a serious misconduct or breach of relevant laws.[99]

The field survey conducted in 2009 as part of this research showed that in Yogyakarta, the most common formal license of BMT is KJKS (*Koperasi Jasa Keuangan Syariah*), followed by KSU (*Koperasi Serba Usaha*), KOPONTREN (*Koperasi Pondok Pesantren*) and KOPWAN (*Koperasi Wanita*) (see Figure 8.3). Although the cooperative names are different, the basic principle of each cooperative type is identical. The vast majority of BMTs operate in local district areas (130 units), eight units are licensed to operate within the DIY provincial territory, and three units have a national license as BMTs, meaning they are allowed to expand their network of operation across the province's borders.

98 The decree No. 91/Kep/M.KUM/IX/2004 broadly regulates BMT establishment procedures, the modus operandi, products and services, the accounting system and standard operating procedures (SOP). Furthermore, the MENEGKOP-UKM published a decree No. 35.2/PER/M.KUM/X/2007 regarding the KJKS/UJKS SOP; to revise the previous operation manual as stipulated in the decree No. 91/Kep/M.KUM/IX/2004.

99 Liquidation of a BMT institution can be on the initiative of the members and approved in the RAT. In the case of BMT liquidations, most are because of fraud, financial bankruptcy and inactivity for a long period of time.

Figure 8.2. Categories of BMTs in Yogyakarta

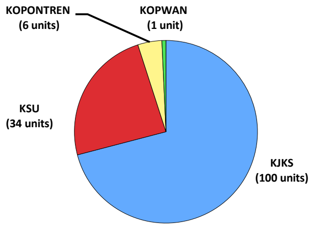


Figure 8.2.a. Type of Cooperative License

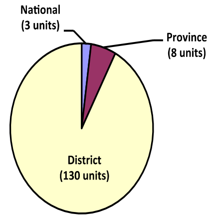


Figure 8.2.b. Operational Coverage

Source: Tabulated from field research and the Cooperative Agency of DIY database (as of May 2009)

Dating back to the origins of the BMT movement, a BMT was categorised as an informal organisation under the government/central bank project (PHBK). After the pilot institutions flourished and many other BMTs were established, there was a need for regulation and supervision because the BMT operations were similar to conventional microfinance institutions that source funding from the community.

Accordingly, Syahbenol Harahap, who was involved in developing the BMT legislative framework, explained:

In the beginning, the MENEGKOP-UKM had difficulty in determining an appropriate legal status for the BMT system because the Cooperative Law does not recognise the Islamic financial modus operandi and at that time, it was impossible to amend the law. After reviewing the previous cases of Baitul Tekhnosa and Koperasi Ridho Gusti [see chapters 6 and 7], the government decided to recognise BMTs as cooperatives and allow them to operate on Islamic principles (interviewed on 2 June 2009).

In addition, Aries Muftie points out that the granting of cooperative status is a compromise solution in order to legalise the BMT system and allow it to attract members and mobilise funding (interviewed on 19 May 2009).

To some extent, however, the current legal status has been under debate among BMT activists and proponents. On one side of the debate, some respondents suggest that the cooperative license provides an adequately legal platform for BMT. They point out that the fundamental cooperative principle is consistent with the Islamic economic concepts (*Muamalah* and *Sirkah*) which were practised during the era of the Prophet and his companions. More importantly, the current regulation is seen as ‘blessing factor’ that could foster the development of the BMT sector as there are a number of advantages of the MENEGKOP-UKM regulation:

- It is less complicated compared to the Banking Law and the Multi Finance Law, hence the administrative requirements to establish a BMT institution are very flexible in that only a small amount of capital is required.
- There are no specific technical qualifications required for management and staff.
- The establishment process is faster because the license can be granted by a district administration.
- The loose government supervisory system means the operations of the BMTs are more flexible than the Islamic banks and other formal financial institutions.
- Finally, from a philosophical perspective, the cooperative movement seems interwoven with the values of the BMT movement to empower the Muslim community through democratic active participation, resource distribution and community-based development.

On the other side of the debate, others argue that the MENEGKOP-UKM regulations are insufficient to accommodate the idiosyncratic features of the BMT system that are considerably different from the generic cooperative arrangement. The opponents claim that the regulations have failed to protect and foster the development of BMT as an infant microfinance sector. They say that the inadequate legal status undermines the development of the BMT sector. Although the government has enacted the KJKS license and regulation to accommodate the BMT sector, from a legal perspective, Amalia (2009) notes that the MENEGKOP-UKM regulations have a lower status in the hierarchy of the National Legal System, thus it does not grant the BMT sector an equal position with the conventional cooperative system, which is regulated under the Cooperative Law.

Accordingly, because it operates under MENEGKOP-UKM regulations, the BMT sector is not positioned in the strategic framework of the national microfinance policy as its conventional counterparts. However, Ninik, the Deputy Director of the Islamic cooperative of the MENEGKOP-UKM, argues that the government supports the BMT movement because it is suitable for the majority Indonesian Muslim population and the

MENEGKOP-UKM demonstrates that support by formulating a fair policy including providing a revolving fund scheme, technical assistance and capacity-building programs to foster the development of the BMT sector (interviewed on 6 May 2009).

It cannot be denied that the current legal status of the BMT system is an interim legal framework to accommodate the inception of the BMT system. Syabenol Harahap, Chairman of the Indonesia Cooperative Board of Yogyakarta and former a Director of MENEGKOP-UKM, admits that it is not easy to amend the Cooperative Law or to propose a law regarding the BMT system, because the political process in the parliament would be complicated (interviewed on 2 June 2010).

Another effort to accommodate the BMT system into the legal system took place in 2007 when the Regional Representative Council (DPD) proposed the Microfinance Law in order to provide a specific legal framework for the BMT system as Islamic microfinance institutions separate from the conventional cooperative system. Unfortunately, the attitude of the government towards the BMTs' legal status remains the same. The government believes that the BMT system should be accommodated under the Cooperative Law.

Apart from these debates, the most important issue to be addressed is how to treat the BMT system as a form of cooperative microfinance. BMT needs a specific legal and regulatory framework in particular to accommodate its idiosyncratic modus operandi. According to Cuevas and Fischer (2006) there are three critical aspects of a cooperative microfinance regulatory framework and these can be adopted in the Cooperative Law or the Microfinance Law.

1. Ideally the legal framework for microfinance cooperatives including the BMT system should be separated from the generic cooperatives because the idiosyncratic nature of the financial intermediation activities (loan and saving facilitation) involves financial risk due to the agency problem and economic uncertainty.
2. The law is in place to protect the institution, members and the sector. Thus, it is critical to design a robust supervisory system in order to protect BMTs from conflict of interest both between net borrowers and net savers, and/or between the management and members. The proposed law should strengthen the role of MENEGKOP-UKM and local government as external supervisory bodies. In this

regard, supervision and law enforcement are essential in order to ensure good governance practice, and to circumvent improbity and fraudulent activities.

3. The policy would improve the sector's competitiveness, productivity, efficiency and sustainability through capacity building programs and access to funding. Equally important, the policy should ensure BMTs are able to maintain their dual mission both as financial intermediary agents and as a socio-religious movement with a mission to alleviate poverty in society.

8.2.5. BMT Supervisory and Governance System

As for its generic counterparts, the supervisory and governance framework is very important for BMT. It is obvious that a sound and healthy BMT sector is determined by how the management performs daily operations. Sound governance is necessary to ensure that the operation complies with laws and regulations.

The general practice in the BMT sector is that the board of management is overseen by internal and external supervisory bodies.

The Cooperatives Law states that the primary role of the government toward the cooperatives sector is as a regulator, supporter and facilitator. However, the MENEGKOP-UKM policy demonstrates that the government has a limited role in daily monitoring of the management of the cooperatives including the BMT sector.

The BMT supervisory mechanism is regulated in the MENEGKOP-UKM decrees: No.35.2/Per/M.KUKM/X/2007 and No.35.3/Per/M.KUM/X/2007. These regulations outline the supervisory and monitoring procedures and also specify the main roles, duties and responsibilities of the official government supervision of the cooperatives sector, including the BMTs. The decrees specifically stipulate a compulsory audit for all BMTs with a total loan portfolio over IDR 1 billion; the annual financial audit must be carried out by a public accounting office or registered cooperative audit agency.

The internal supervisory framework of the BMT system is embedded in the institutional structure. The self-monitoring function is carried out by a supervisory board on a daily basis and by the collective monitoring of the members. The supervision of BMT operations comprises of a management supervisory board and a Sharia supervisory board. These boards are appointed by the board of management with endorsement of the members at the AGM.

- The management supervisory board (DPM) consists of three members competent to perform supervision and monitoring including audit functions. The DPM monitors the BMT's operations regularly by conducting offsite and on-site inspections of the overall operation, management performance and financial sustainable.
- The *Sharia* supervisory board (DPS) is set up to oversee BMTs' operations, specifically whether it is consistent with Islamic financial transaction jurisprudence (*Fatwa* of MUI), including to what extent the institution is run according to the general socio-religious norms of the community (see also Section 8.2.1.). The DPS comprises one to three members who should have sufficient knowledge both in *Sharia* law and economic areas. The role of DPS is to independently examine the compliance of financial contracts, the accounting system and the entire scope of the BMT's operations. If the BMT management breaches a *Fatwa*, the DPS should respond immediately and suggest the manager take appropriate corrective action.

In relation to the internal BMT supervisory mechanisms, the functions of the DPM and the DPS are clearly delineated and both are under the coordination of the management board. This board is responsible for examining the monthly monitoring reports from DPM and DPS, and at the end of financial year, the report should be approved by the members at the AGM. Then, the approved annual report, including the financial statement, is submitted to the government agency where the BMT is registered for further assessment.

The BMT supervision methodology (the MENEGKOP-UKM decree No. 35.3/Per/M.KUM/X/2007) explains the nature of the assessment process that can be performed through on-site and off-site supervision. On-site visits and interviews are conducted with the board and management, while the off-site techniques involve an examination of the main financial reports, including the balance sheet and profit and loss statement.

The core of the BMT assessment comprises eight financial and non-financial indicators: capital, asset quality, management capability, efficiency, liquidity, self-sufficiency and growth, cooperative identity, and *Sharia*-compliance. Five of those elements – capital, asset quality, management capability, efficiency, liquidity performances – are examined through the CAMEL assessment that is adopted from commercial banking practice. Self-sufficiency and growth indicators are examined using the quantitative assessment method that was developed by the MENEGKOP-UKM. The other indicators (management capability and *Sharia*-compliance) are carried out by using a qualitative approach through a list of questionnaires, whereby each indicator is weighted and scored proportionally and, at the end, the scores are tabulated to determine an overall classification. The four categories of the BMT performance are described in Table 8.3.

Table 8.3. Composite Classification of BMT Institution Performance

Management and financial assessment	**Score**	**Explanation**
Sound	81 ≤ 100	Indicates BMT performance is superior.
Fairly sound	66 ≤ 81	Depicts a performance above average, strong operation and sustainable.
Less sound	51 ≤ 66	Represents a lower performance that is below average with several areas of weaknesses hence in the long-term perspective could threaten the sustainability of the BMT institution.
Unsound	0 ≤ 51	Suggests a lowest performance and critically vulnerable, with a high ratio of NPF, inefficient, unprofitable, breach the rules etc. therefore it need immediate actions to improve the performance.
***Sharia* Compliance**		
Complies	7.51 – 10	Demonstrates the BMT operation fulfills all relevant *Fatwa* and the *Sharia* principles.
Satisfactory compliance	5.01 – 7.5	Suggests that BMT institution need to carry out further correction toward specific transactions as stated in the *Fatwa*.
Less compliance	2.51 – 5	Implies BMT institution to some extent violates the *Fatwa* and strongly advised to review the operation procedures.
Does not comply	0 – 2.5	Indicates BMT institution substantially breaches the *Fatwa* and the *Sharia* principles.

Source: MENEGKOP-UKM, decree No. 35.3/Per/M.KUM/X/2007

As previously mentioned, the current BMT evaluation model is a mixture of the Islamic banking assessment methodology (CAMEL and *Sharia* compliance module) and the general cooperative assessment procedure. However, the method does not fully encompass the nature of BMT both as a faith-based financial cooperative and community-based microfinance institution because of several limitations.

First, in the microfinance sector, ideally the assessment should consider a three-dimensional microfinance context – sustainability, outreach and impact (Zeller and Meyer 2002). In fact the current assessment only focuses on financial and managerial issues.

Second, given that in the BMT sector there are subsidised government funds in the BMTs' lending portfolios, it is important to measure the effect of the subsidy on the sustainability of the BMT institution. This is not considered in the MENEGKOP-UKM supervisory system (see further discussions in Chapter 9).

Finally, as BMT financial operations consist of minuscule transactions, its *Sharia* compliance should be more specifically designed, instead of using the Islamic banking model. In this regard, the MENEGKOP-UKM and the Indonesian Islamic Council (DSN-MUI) should design a *Sharia*-compliant module which is suitable for BMT.

The conceptual framework of the BMT supervisory system emphasises that the MENEGKOP-UKM or the cooperatives government authority is the main institution responsible for the supervision of the soundness of the BMT sector. Within the MENEGKOP-UKM organisational structure, there is a section responsible for supervision. However, field observations suggest that the government has relinquished this monitoring role to the BMTs themselves.

This study confirms previous research that the government agencies do not adequately oversee the BMT sector; this lack of supervision applies not only to the BMTs but also to the entire cooperative sector (Seibel 2008). The main problem is the lack of competent supervisors to perform routine monitoring of cooperatives. Even though the BMT system is less complicated than the banking system, there is a need for specific supervisory knowledge and skills to understand the nature of the financial transactions especially those conducted using the Islamic financial model.

Government supervision has become even more complicated since the regional autonomy regime has been implemented in the early 2000s. The MENEGKOP-UKM and the local authorities have encountered a shortage of experienced and skilled supervisors because many of them have been moved to positions in other government agencies. Another critical issue is the insufficient budget allocation to support the government monitoring function, as stated by Bambang Harimurti and Titik. They state that since the role of the government is mainly as a facilitator, hence the budget allocation is focused more on strengthening the capital and liquidity of the BMT sector, in particular after the earthquake disaster, and to improve quality of the BMT management and staff by conducting regular training programs (interviewed on 8 June 2009).

Accordingly, to deal with limited resources for competent supervisors and an adequate budget, the supervisory agency is likely to employ a minimalist strategy of off-site supervision) by requiring BMTs to submit their AGM reports to be used as a database to carry out the institutional assessment, instead of conducting regular on-site supervision.[100] It is obvious that this minimalist monitoring approach is usually unable to detect internal managerial problems and fraudulent activities, and thus there is a failure to undertake immediate and appropriate actions whenever there is problem in a BMT.

Within the BMT, supervision problems arise because most members of the supervisory board have little or no experience and knowledge regarding the general nature of Islamic banking and Islamic microfinance, especially BMT financial operations. As discussed in the previous section, many of the board members are clerics and others who have no expertise in finance. Most board members are not qualified to occupy the position and carry out a supervisory role.

From the surveys conducted and discussions with key informants, the findings show that in many BMTs, the internal monitoring function does not work effectively as specified in the supervision guidelines. The DPM position seems only a formal structure because, in practice, the manager is the key person responsible for managing and monitoring the entire BMT operation. It can be seen from the AGM reports that the boards are likely only to issue a normative statement rather than a monitoring report to portray the factual condition of BMT. There have been several cases of mismanagement

[100] The MENEGKOP-UKM decree stipulates that the BMT institution must submit its annual general meeting report and, more specifically for BMT, which manages over IDR 1 billion, its financial statement must be audited by a public accountant.

and fraud in BMTs that were not reported until they were exposed to the public by staff and members[101], i.e. the case of BMT Amartani (see further discussion in Section 9.5.1).

Similarly, the research findings reveal several shortcomings relating to the *Sharia*-compliance issue. Referring to Muhamad (a member of the DPS of several BMT institutions), the problems arise because the DPS function in the BMT organisational structure was ineffective (if any) or absent since in the beginning. The majority of DPS members do not have an adequate knowledge of Islamic banking and financial standards and practice (interviewed on 15 July 2009). Totok Suparwoto, a BMT activist in Yogyakarta, recognises the problem:

In the beginning we encountered tremendous challenges because the background of the majority of BMT personnel was in Islamic teachings and social sciences. In other words, when we established the BMTs, the religious spirit and motivation to promote Islamic values was more dominant than the banking and microfinance practical knowledge (interviewed on 23 June 2009).

A study of the Islamic Development Bank Research and Training Institute (IRTI) suggest a similar finding – that the *Sharia* governance practices within the Islamic microfinance sector, i.e. the BMT sector, is not standardised and therefore it is difficult to assess the level of compliance (IRTI 2008). Not surprisingly, Muslim scholars who have scrutinised the operations and practices of BMTs have expressed concerns about the governance and compliance of their *Sharia* modus operandi (Karim et al. 2008). This concern is also highlighted by Suryadarma Ali, the Minister of Cooperative, Small and Medium Enterprises for period of 2004–09. He criticised the practices of some BMTs that fail to satisfy the *Sharia* compliance regulations (Eramuslim 2007), for instance the cases of 22 BMTs in the Serang District of Banten province (BPK 2006). Hartarska and Nadolnyak (2007) point out that ineffective regulation, supervision and governance framework has been costly for BMTs and the entire microfinance sector.

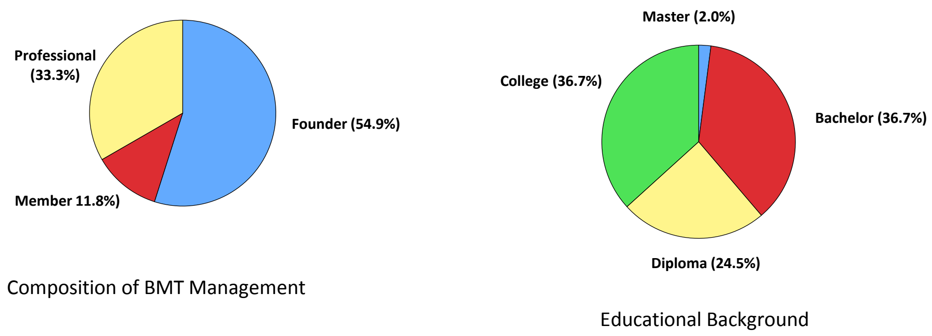
[101] In beginning of the study there were several BMTs involved as samples, but without explanation reason the BMTs withdrew as they did not submit financial reports. An informal confirmation mentions that the BMTs faced financial problem due to mismanagement and fraud.

8.2.6. Management and Human Resource Profile

In the structure of BMT organisation, the manager is the key person who is responsible for the daily operations of the BMT. In general, the quality of the managerial role and leadership determines the success or failure of the BMT from its establishment, thus the manager is the key success factor for the sustainability of the BMT.

Based on field research (Figure 8.3.) the management of BMTs is dominated by well-educated persons. More than half of the managers have graduated from university with degrees or diplomas, and another one-third hold college certificates. A majority of managers are followers of Muhammadiyah, but only a few of the managers have an entrepreneurship background or are associated with a political organisation.

Figure 8.3. Profile of BMT Management in Yogyakarta



Note: n = 55

This study supports the view that on the whole the BMT sector meets the general standard of the microfinance sector. However the interviews confirm that nearly all of the BMT managers are not graduates from economics, banking and finance faculties or courses. Instead, their academic background is in Islamic teachings, education and the social sciences. As discussed earlier, the interviews and survey data suggest that in the early stages of the establishment of a BMT, most BMTs have been struggling with the lack of competent human resources because – apart from religious motivation and knowledge – the majority of managers are inexperienced in banking and finance, especially in running a faith-based microfinance program.

To deal with this shortcoming, the managers usually attend a short course on the basic model of the Islamic financial microfinance system and the Islamic leadership development program. Subsequently they follow an internship period in other BMTs or in BPRS to understand the nature of the operation of the BMT system. The primary training providers are PINBUK and the BMT Center, which are the organisations that also provide technical and funding assistance (see further discussion in Chapter 7).

The MENEGKOP-UKM and local government agency also run several training activities over the fiscal year, especially to discuss more advanced curriculum or particular topics that related to the government budget. In 2009, the MENEGKOP-UKM designed a competency-based certified system for the manager and board members. The objective of the assessment and certification is to standardise the proficiency of the BMT manager and to ensure BMTs are managed by suitably qualified managers.

When examining the profile of BMT management, it is evident that more than half of the managerial positions in BMTs are in the hands of the influential founders. Another third are managed by professional managers, and only a few BMTs are controlled by the members.

The involvement of the founders in the management of BMTs is a strategic decision. It is a means to maintain the mission of the BMT and avoid the example of some microfinance programs that have lost their mission when they expand and become profitable. Also, according to Mardiono, founder of BMT Mitra Usaha Umat in Yogyakarta, the presence of a founder in management has the specific intention of maintaining the interest of the founders in the development of the BMT's business strategy. Many of the BMT founder-managers are influential Muhammadiyah figures from well-established family backgrounds, with a university or college education. Appointing high profile founder-managers from these backgrounds assists the BMT to attract new members and establish relationships with government agencies (interviewed on 18 June 2009).

However, the typical founder-manager tends to be a 'one-man show', especially if there is inadequate supervision from the board. In such cases there is a risk of poor governance and mismanagement. Another drawback is control by the founder-manager will lead to a problem in the long term because there is no leadership succession plan for the future of the BMT.

Interestingly, some other BMTs, often well-established ones, employ a professional manager to run the operation. The typical professional manager is recruited by the founder and/or board of management from within the institution, usually a senior staff member who has longstanding experience and has gained the trust of the founder and the board.

Mursida Rambe, founder of BMT Beringharjo, points out that trustworthiness and integrity are very important characteristics in the selection process, since the manager is the key person responsible for the BMT's development and to keep the BMT mission on track. Other essential criteria of the manager are that the person should show excellent leadership and have a career record in business, be well known to the members and local community, and have an adequate knowledge of Islamic business values (interviewed on 4 June 2009).

There are some very rare cases where the BMT manager is recruited from outside the institution, mostly from another BMT. The main reason is lack of trust. It is also difficult to find candidate BMT manager in the market. If there is any, it is more common for talented BMT staff and manager to seek a better career in the banking sector (in either a conventional or Islamic bank) as it offers better prospects for a future position, improved salary and status, rather than a apply as BMT manager.[102]

Under the BMT staffing structure, under the manager there are several positions such as a marketing or lending officer, teller, administration or accounting officer and the *Baitul Maal* officer.

The survey on the profile of the BMT staff found that the majority (69.2 per cent) of BMTs' staff have graduated from high school or college (*Sekolah Menengah Umum* or SMA & *Sekolah Menengah Kejuruan* or SMK), while 17.9 per cent have diplomas and a further 12.8 per cent have bachelor degrees. It seems that the standard approach of BMT human resource management (HRM) is to employ employees with lower qualifications to fill the clerical positions because the BMT modus operandi is fairly uncomplicated –it involves basic lending and saving procedures, hence high school qualifications are thought to be adequate for most positions in the BMTs. In addition, by

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102 There is an informal agreement that BMT would not recruit existing personnel from other BMTs, thus the turnover of BMT personnel seems very low.

recruiting high school graduates this reduces the operational costs of salaries and other fringe benefits, and it reflects a preference of many BMTs to recruit from their own community. Finally, Yogyakarta is a very famous education centre, with many university and diploma as well as high school graduates in the local job market.

However, in the recent years, in line with the significant expansion of the sector, well-established BMTs have attracted new diploma and university graduates with an economics and business studies background to fill important positions such as marketing or lending officer. This policy is employed in order to address the increasing competition in the microfinance market, and also to develop a younger generation of personnel in BMTs. In this context, because of the long-term domination of the founder-manager in management positions, a large number of BMTs face a shortage of skilled and experienced staff with whom to develop new branch networks.

In contrast to the selection of managers, the recruitment of staff is largely from external sources. Normally, BMTs advertise positions in local newspapers and/or through the student associations of Islamic universities. The well-established BMTs usually employ a selection process consisting of administrative screening, a general academic test, Islamic knowledge (reciting the Qur'an) and an interview. However, for smaller BMTs, the recruitment procedure is less complicated and they rely more upon internal references in order to minimise costs.

The successful candidates attend a short introductory training and internship program to provide them with the knowledge and technical skills used in BMT operations. For recruitment as a marketing/lending officer, the training curriculum is more specific, using an experiential learning methodology and hands-on coaching and mentoring from the manager and/or the senior staff. This specific curriculum enables the candidate to understand the salient features and the potential risk of the BMT loan products.

BMT managers, when interviewed, report that the staff recruitment process is very time-consuming. They also say that it is quite difficult to obtain qualified staff from the local employment market. Karim (Manager of BMT DT) notes that in many cases most of the applicants are under-qualified intellectually and in terms of banking knowledge and overall performance (interviewed on 28 July 2009).

According to Rama Widia (Manager of BMT Al-Ikhwan), young graduates do not consider a career in the BMT sector as a promising choice for a future livelihood. As the BMT is a community-based microfinance institution that pays low salaries, he considers that the main motivation of the applicants is religious rather than money. However, from casual discussions with some BMT staff, it seems that they work in BMTs not merely for religious reasons, but rather they are conscious of the limited opportunities to find a better job, to work close to home (a preferably situation for female staff), and with a less rigorous selection process for those graduates who have lower academic qualifications. It is worth nothing that the BMTs have experienced a very low rate of staff turnover.

Remuneration is one of critical issues in the BMT sector. Like other local community-based microfinance institutions, such as the LPD in Bali (Arsyad 2006), the remuneration system of BMTs consists of a basic monthly salary plus a bonus. The salary is based on the minimum regional wage that is determined by the DIY administration. The average salary for the manager is roughly equivalent to that for a clerical position in the banking sector, and the staff earns similar to clerical or manufacturing wages. However, well-established BMTs, with better financial performance, pay their managers and staff slightly above the average. In some cases, these institutions also pay additional fringe benefits such as basic health insurance or medical treatment allowances, and accident insurance on top of the salary package.

In addition to the monthly salary, BMTs typically provide a bonus and incentives to acknowledge outstanding performance by the manager and staff. There may also be a ‘best practice’ bonus or an incentive plan in the banking and financial sector, the primary objective of which is to encourage employees to perform beyond expectations, or to exceed targets. More technically, the bonus scheme is related to monthly performance indicators in particular funding mobilisation, loan disbursement, non-performing loans (NPL), and bottom-line profitability. The bonus is paid on a monthly basis. Finally, annual profit-based bonuses are allocated proportionally among the manager, marketing and credit officers, administrative staff and tellers. The incentive scheme is usually timed in association with a religious festive such as *Tunjangan Hari Raya* (THR) at the end of Ramadan. However, the BMT institution does not provide a monthly basic salary for the supervisory board; instead there is an annual bonus based on the profit of the BMT, which acts as an incentive for each supervisory activity.

In summary, it seems that there are strong and weak points concerning the HRM practice in the BMT sector Overall, the BMTs seem to have recognised the importance of human resources in achieving sustainability (FGD, 20 August 2009 in Yogyakarta). However, there are some critical issues that challenge the BMT management and those should become a priority to be addressed, especially the need for improvement in the competence and capacity of personnel through training, and succession planning at the managerial level. Equally, it is also important to provide a better remuneration scheme in order to motivate the employees and to retain outstanding personnel.

8.2.7. Membership System

Like cooperative institutions in many countries (Davis 2007), the BMT is a membership-based institution. The common principle is that it is a mutual organisation that is owned, managed and governed by the collective membership, and the members are also the clients. The BMT clients are individual members associated by common bonds and interests.[103] The BMT is an Islamic community-based microfinance institution made up of members with similar religious beliefs and socio-cultural-economic backgrounds. The membership of a BMT is very similar to that of a general cooperative involving a non-transferable share of nominal capital; one member is entitled to one vote with no proxy vote allowed.

In general, the Cooperative Law and the MENEGKOP-UKM regulate the membership system of BMTs. They mandate that the definition, and terms and conditions of the membership as well as the recruitment procedure must be defined and stated in the BMTs' Charter (AD/ART) and approved at the AGM. The BMTs have open membership conditions, so that anyone can join as long as the membership rules and regulations are fulfilled.

[103] Membership of BMTs is that of an apex cooperative; see also Chapter 7 regarding apex cooperatives.

There are three classifications of membership in BMTs:

1. The first category is full membership, which is granted to a member who complies with the administrative requirements, terms and conditions, and deposits a specific amount into a compulsory savings account (see also Chapter 9). As previously mentioned, full membership provides equal voting rights and participation at the AGM regardless of how much money has been invested, as well as the right to use the services provided by BMT.
2. The second category is special membership. This is designed to accommodate a member who is unable to meet a specific term or condition of full membership, for instance the member is not registered as a local resident in the area where the BMT operates; or the member may have a specific reason to ask to be a non-voting member.
3. The last category – temporary membership – is specifically granted to a candidate who cannot fulfil one of the major requirements, e.g. they are unable to deposit the full amount required in the compulsory savings account at the time of registration; this membership category is valid for a maximum period of three months.

From the regulatory perspective, temporary membership status is seen as a limitation. However, BMTs take advantage of this restricted membership category to recruit members, in particular for the purpose of attracting deposits.[104] As community-based microfinance institutions, BMTs find it difficult to achieve self-sufficiency in funding, especially when they are located in less-developed areas. To deal with this constraint, BMTs use the temporary membership status as a means of attracting wealthy depositors to invest their funds without a long-term commitment as a BMT member.

From the perspective of regulation and supervision, Bambang Harimurty, the head of the Cooperatives Agency of the DIY province, notes that the contradictory regulations present MENEGKOP-UKM with a dilemma. On one hand, the government encourages the BMTs to grow and develop in the community, but, one the other hand, the use of the temporary membership status to attract funds breaches the regulations (interviewed on 9 June 2009).

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[104] BMTs are not allowed to mobilise funding from non-members or the public (see also Chapter 9).

But from a different perspective, Mardiono, the founder of BMT Mitra Usaha Umat in Yogyakarta, suggest that the temporary membership status is also a worthwhile mechanism to screen potential new members. As an institution with a policy of open membership, a BMT institution is vulnerable to intervention, in particular when it is growing and profitable. A common case is when a wealthy 'outsider' joins as a member to influence other members during the AGM in order to take over the management and gain overall control of the BMT to further his/her own interests (interviewed on 18 June 2009).

In general, there are two main categories of members. By using the religious social capital analysis (Harrigan and El-Said, 2009), the typical BMT members can be identified as sharing similar spiritual, ideology and socio-cultural backgrounds as Javanese and Muslims, and with the exception of one BMT, members do not have an affiliation to a particular political party or organization or an *Aliran* identification such as *Abangan*, *Santri* or *Priyayi*.

- There are the investor members who tend to have better educational and economic backgrounds, who work as entrepreneurs, civil servants, lecturers, teachers, clerics and in other professions. Using the Geertz' definition, they belong to the *Priyayi* and *Santri* categories (Geertz 1960). They join a BMT because they support the mission of the BMT in providing *Sharia* microfinance and helping poor people, they invest money for a high return (above the commercial bank deposit rate) and use the BMT services to support their business activities. The investor members are usually net savers, not borrowers.
- The borrower members are usually members of the local community in which the BMT operates and in *Aliran* terms are more *Abangan* in orientation (Geertz 1960). The borrower members form the majority of the members and are motivated by pragmatism and economic interest because the BMT offers cheaper and better microcredit than the moneylenders and other informal microfinance providers. The profit sharing approach, rather than payment of interest, the more humane approach to collecting bad loans, and a location close to their business are all attractive features. The most common borrower members are traders, informal workers, casual labourers and low-income wage earners. For commercial bank providers of credit these members are considered un-bankable.

8.3. BMT Modus Operandi and Operational Outreach

As stated in the Cooperative Law and MENEGKOP-UKM regulations, BMTs mainly provide community-based microfinance that focuses on the area of a village and/or sub-district.[105] Predominantly, the BMTs operate in the traditional markets and local business centres of the villages and in suburban communities in the intersection between Yogyakarta city, Sleman and Bantul regencies.

The BMT model is naturally flexible, highly mobile and pro-active (*Jemput Bola*). The BMT officers visit the client (OVC) regularly to arrange and complete saving and deposit transactions, loan disbursements and instalment collection (see detailed discussions in Chapter 9). Equally important, the traditional marketplace is critical for BMTs because the majority of BMT client members are petty traders and microenterprises in areas surrounding the market.

Maya Dayu Murti (the Branch Manager of BMT Beringharjo) points out that the OVC methodology and its focus on the operational and target market in specific areas allows BMTs to conduct their operations efficiently in the fields of membership recruitment, marketing activities, arranging saving and deposit transactions, and loan disbursement, collection and monitoring (interviewed on 8 July 2009). In addition, from the perspective of BMT operations, this approach has several advantages. First, having the officers visit the client is a very effective means to establish a close relationship with the client members and monitor the daily performance of their businesses. Second, it allows the BMT to reduce operational costs in the relationship with members. Third, for the clients, the BMT service is regarded as highly satisfactory, as they can perform the financial transactions on their own premises.

There is a growing concern that many independent grocery stores, as well as national-wide convenience store chains like Alfa Mart, and Indomart, operate very close to the traditional markets. The presence of these sophisticated franchised stores threatens the existence of petty traders. The chains are in direct competition with the traders, in that they offer lower prices and better-quality products, and at strategic locations compared

[105] Although BMTs are allowed to hold national and provincial operational licences, the physical site of branch offices should be in the community area.

to the traders. Many traders who are BMT clients experience declining sales and profits which impacts on their capacity to pay their loan instalments, which in turn influences the overall BMT performance. Tatik asserts that this issue has attracted the government's attention; for instance, the Bantul district administration does not allow convenience store chains to operate close to the traditional market and in the villages (interviewed on 15 May 2010).

8.4. *Baitul Maal* Function and Performance

As described in section 8.2.1 and chapter 7, BMT carries out its socio-religious mission through the *Baitul Maal* unit. The basic socio-religious activity is to gather alms and donations (*ZIS*), and to distribute the funds to destitute households and the needy who live in the region surrounding the BMTs.

In general, the model used by *Baitul Maal* in collecting the charitable funds is very simple and straightforward. Alms collection is focussed on internal BMT and external sources. The internal BMT sources are mainly the annual profit of BMT, the founders, board of management, manager, staff, and their family member. The BMT deducts 2.5 per cent of the annual net profits (if any), and similarly, BMT directly debits 2.5 per cent of the monthly salary, annual bonuses and marketing incentives of the manager and staff[106] for almsgiving, which supports the *Baitul Maal* activity and charity program.

The external sources of *Baitul Maal* funds are the members, the community surrounding the BMT, private businesses, state-owned companies, philanthropic organisations (*LAZIS*) and other donor institutions. Normally, the *Baitul Maal* obtains donations – *ZIS* – from external parties through personal approaches and by submitting a formal proposal. The personal approach is used to persuade the BMT members, especially affluent investors and borrowers. The collection of alms can be performed by directly deducting deposit and/or saving return or during loan collections. When a private and state-owned company or LAZIS is approached, *Baitul Maal* would propose a comprehensive funding schedule that states the amount of funds provided, and details the charitable activities or beneficiaries. In addition, some *Baitul Maal* of BMTs place

[106] The general assumption is that the incomes of the BMT manager and staff exceed the minimum threshold of almsgiving.

donation boxes in community mosques, convenience stores, restaurants and other public places.

According to Ruby, manager of *Baitul Maal* of BMT Beringharjo, obtaining charitable funds, particularly from external parties, is a very challenging task because it is not easy to convince people and organisations without a thorough program proposal and personal or business networks. The constraints *Baitul Maal* face in collecting alms and donations are that the funds from internal BMT sources is relatively limited, as the annual profit of BMT and the monthly income of the manager and staff is small. While attempting to obtain charity funds from the BMT members, founders and supporters are frequently reluctant because it is a common practice for people to prefer to distribute their *ZIS* to particular beneficiaries, including their close relatives, neighbours and orphans. Collecting *ZIS* from business and philanthropic institutions is even more difficult, since the BMTs' *Baitul Maal* programs have to compete with fund raising from other LAZIS. In Yogyakarta, the *Baitul Maal* of BMTs usually compete with Rumah Zakat, DDF and other local LAZIS (interview on 23 August 2009 and 13 May 2011).

In channelling *ZIS*, generally, *Baitul Maal* follows the recommendation of the Qur'an (see discussion in Chapter 2). Alms are distributed to destitute households, orphans and the elderly, single mothers, poor students and other needy beneficiaries who live in the region surrounding the BMT. Donations are directed towards broader purposes, including the building of mosques, provision of the Qur'an for the mosque library, for annual religious ceremonies and regular spiritual activities (*Pengajian*), and to support natural disaster relief programs. The *Baitul Maal* programs around Yogyakarta provided natural disaster relief after the earthquake in 2006 and the volcanic eruption in 2010. As BMTs and their *Baitul Maal* are community-based institutions, therefore many international donors and government agencies distribute funds for emergency and post-disaster recovery programs through BMTs to reach the affected villages and households (see also discussion in Chapter 9).

In other cases, several BMTs channel donations towards benevolent loans (*Qard al Hasanah*). The scheme is categorised as a 'soft loan' to provide capital for poor people starting and/or running productive activities and microenterprises. The borrower is not obliged to pay back the loan if the financed business becomes bankrupt or generates insufficient profit (see discussion in Chapter 2). The benevolent loan scheme is designed to empower poor beneficiaries to be economically self-reliant and enhance their spiritual and social self-esteem. However, the practice of benevolent loans seems unsustainable and BMTs have encountered some impediments.

First, the source of funds for benevolent loan is limited and irregular and thus it limits the capacity of BMTs to provide these loans to more than a small number of borrowers, and to sustain the loan disbursements over time. Second, not many potential borrowers meet the requirements and need for these loans for running their business. In many cases, the borrowers request loans for household consumption, i.e. buying daily food. Third, during certain times like election campaigns (*Pemilu* and *Pilkada*), BMTs have to compete with the government charity program[107] that provides very similar but larger loans with less paperwork and requirements.

The impact of the policy is to increase the possibility of improbity, and a misleading perception among people toward benevolent loans and the image of BMTs. Finally, the BMTs face a detrimental community attitude where people regard BMTs as charitable institutions and avoid paying back loans. In this instance, the loan default influences the overall BMT performance. As a result, many BMTs have discontinued benevolent loan disbursements. In general the *Baitul Maal* activities are focused on *ZIS* distribution and supporting religious programs.

8.5. Summary

The discussion in this chapter has addressed the research questions relating to the dynamic development of the BMT institution in Yogyakarta.

The BMT movement in the Yogyakarta community had its origins in the New Order government's accommodation of the revival of Islamic values and activism. The BMT system was originally inspired and designed by the modernist Muslim elite in Jakarta, many of whom were associated with the modernist orientated and government-supported ICMI. However, the movement was developed in Yogyakarta by Muslim civil society groups, community leaders, intellectuals, clerics and activists of the leading

[107] It is common for the incumbent government to provide charity programs called *Bantuan Sosial*, 'soft loan'.

Islamic organisations, including the Muhammadiyah, who built on local socio-cultural values.

The mainstream of the BMT movement is a blend of idealistic spiritual and economic motivations. Azis (2004) states that the conceptual framework of the BMT is to empower Islamic values, and simultaneously to improve the socioeconomic status and livelihood of ordinary Muslims. According to Harrigan and El-Said (2009), the BMT movement is a form of religious social capital institution that has emerged in Muslim countries. In the context of the Islamic revival, it can be seen as a process of 'Islamisation of Muslims' through the adaptation of modernist Islamic values so that Muslims could better address the dynamic changes in contemporary society.

Alongside the political change and rapid development of the Islamic banking sector, the BMT movement has evolved into a popular Islamic microfinance system. However, it seems that the distinctive socio-religious mission has been gradually transformed into a more profit-orientation purpose in order to maintain financial sustainability. Helm (2006) asserts that the commercialisation demonstrates a mission drift from pro-poor to pro-market. However, Fealy (2008) argues that in the BMT case, the transformative pathway is most likely a phenomenon of 'commodified Islam' in which religious values and symbols are employed as a marketing strategy to reach out to Muslim clients. From a different perspective, the transformation of the BMT movement is also a means of survival and a means to sustain the performance of the movement in the dual banking and microfinance system.

BMT involves a simple institutional arrangement. Community-based microfinance is embedded in a socio-religious tradition (Arsyad 2006) which is easily accepted by local communities. The BMT system is a combination of cooperative microfinance and Islamic attributes and symbolism. The BMT organisational structure comprises a financial intermediary division with its main functions to facilitate savings and to disburse loans to the client members. The other function is to perform Islamic philanthropic activities by collecting and distributing charitable funds for poverty alleviation. In addition, supervision and governance of the BMT comprises internal and external mechanisms, including the *Sharia*-compliance module.

The distinctive BMT model, by employing the OVC methodology, allows it be close to the client members who are predominantly petty traders, microenterprises and workers in the informal sectors of the traditional markets. The mixture of a microfinance approach and philanthropic activity through *Baitul Maal* allows the BMTs to perform dual functions in economic development and socio-religious empowerment. However, the twofold missions create a dilemma since some people misunderstand the role of BMT as a faith-based microfinance institution with its *Baitul Maal* mission. In the next chapter, the discussion will focus on an examination of the BMT's performance and identification of the determining factors that significantly affect the sustainability of the institution.

CHAPTER 9
PERFORMANCE OF THE BMT INSTITUTIONS

Sustainability is an essential requirement for BMTs to continue operations over time and for them to achieve their mission and objectives. Sustainability is usually demonstrated in terms of financial performance indicators and quantitative measurements.

In this chapter, the data relating to the performance of the BMTs is based on the financial reports of BMTs included the surveys conducted for this research, together with other relevant information gathered during fieldwork in Yogyakarta and Jakarta from 2008 to 2011[108]. The analysis and discussion address the following main research questions:

- to measure the performance and sustainability of BMTs;
- to examine how the Islamic community-based microfinance system sustains its operations and to what extent being faith-based makes the BMTs more sustainable;
- to determine what factors influence the sustainability of the sector.

The first part of the chapter describes the BMT sector in the DIY province. Due to the limitations of the database generated from the mail survey of the provincial cooperative agency, the analysis aims solely to examine key financial indicators such as loans, deposits, profitability and capital. The following discussion examines the sustainability of the selected BMTs as being representative of the overall BMT sector in the region. As described in Chapter 3, the framework of performance and sustainability analysis is adopted from the PEARL, MENEGKOP-UKM and the Mix Market methodologies. It addresses three main financial aspects of BMTs:

- assets and liabilities performance, growth trends;
- profitability analysis; and
- to examine sustainability through operational self-sufficiency (OSS) and financial self-sufficiency (FSS).

[108] Performance analysis of BMTs was based on financial report 2008 – 2010 that have been approved by the BMTs annual general meeting (AGM) in March – April 2011.

Finally, the chapter's conclusion includes an introductory framework for the thesis conclusion and recommendations.

9.1. General Performance of the BMT sector in Yogyakarta

To accurately assess the performance of the BMT sector and the cooperative sector in general in Yogyakarta is not straightforward, because (as discussed in Chapter 8) the regulatory and supervisory body is not centralised under the coordination of the central and provincial government. Instead, the function is managed by several district administrations through different local government agencies.

Officially, based on database of the Cooperative and SME agency of the DIY Government or DISPERINDAGKOP-DIY (survey conducted in April–May 2009) there were approximately 119 BMT institutions active in the region. Among the respondents there were only 100 institutions that completely submitted their current addresses, license numbers and a summary of financial indicators. However, according to Tatik, the head of the *Sharia* Cooperative section of DISPERIDAGKOP-DIY, there were nearly 270 units of active BMT institutions in the region, mostly licensed and overseen by the district administrations (interviewed on 8 June 2010)[109].

Table 9.1. Performance of BMT Sector in the DIY Province (May 2009)

City/District	Number of BMTs	Assets (IDR billion)	Loans (IDR billion)	Deposits (IDR billion)	Profit (IDR billion)
Yogyakarta City	19	71,4	52,9	54,7	0.322
Sleman	34	75,3	53,8	57,0	0.502
Bantul	23	37,1	28,1	27,4	0.09
Kulon Progo	12	13,6	10,7	10,0	0.01
Gunung Kidul	12	10,8	6,8	5,6	0.01
Total	100	208,1	152,3	155,0	1,2
Mean		2,1	1,5	1,6	0.01
Median		1,1	0.8	0.7	0.007
Minimum		0.03	0.02	0.07	-0.2
Maximum		25,4	19,8	20,1	0.2

Source: DISPERINDAGKOP-DIY (2009)

[109] The study focuses on the provincial level and uses the database provided by the *Sharia* Cooperative Section of *Dinas Perdagangan, UKM dan Koperasi Propinsi Daerah Khusus Yogyakarta* (DISPERINDAGKOP-DIY).

9.1.1. Network Coverage and Growth Pattern the BMT Sector

Table 9.1 shows that the BMT network is unequally spread across the districts. The largest number of institutions are located in the triangle spanning Sleman (34 institutions), Bantul (23 institutions), and Yogyakarta city (19 institutions). In general, the geographic coverage of the BMTs outlets is influenced by local socioeconomic structures as well as by the distribution and movement of the population.

As described in Chapter 4, the main focus of economic growth in Yogyakarta is the tourism economy in the same triangle zone. In the surrounding areas, the typical economy consists of microenterprises, cottage industries, handicrafts and service-based self-employment. The sector also contains hotel chains, department stores, traditional markets, convenience shops, street traders, restaurants, tour operators, and other service providers. In addition, in the suburban areas there are many university campuses and Islamic boarding schools, which create community-based economic opportunities such as student accommodation and other support services. Thus, the strong presence of the informal sector and community-based businesses enhances business turnover and the circulation of money that, in turn, stimulates more rapid growth of BMTs.

The local administrations play a critical role in fostering the development of the BMT sector. As asserted by Tatik, the leadership of the districts and municipality government are very supportive by developing favourable policies about licenses, technical assistance and capital subsidies (interviewed on 8 June 2010). The relationship of the BMT movement with local governments was influenced by the support of the Sultan, and also assisted by the typical BMT modus operandi that seeks to empower grassroots economic activity and poverty alleviation, and thus sees the support of BMTs as a means to maintain the popularity of the administration in the eyes of the public.

In the last five years, the BMT sector has rapidly developed in Yogyakarta. The BMT network has more than doubled; from 2000 to 2005 the provincial and district administrations granted new licenses to 73 BMTs. Furthermore, during the study period (2008–10) there were more than 30 BMTs established across the district administrations. This progressive trend is in line with strong economic growth and increasing awareness and acceptance of Islamic microfinance products.

The supporters and practitioners responded differently to the rapid growth of the BMT sector. An optimistic attitude is represented by Mardiono, the Chairman of ABSINDO-DIY, who argues that the successful operations of so many BMT institutions is evidence that the system is accepted and needed by Muslim communities, particularly by members of the community considered to be in the un-bankable segment, which has no access to the formal commercial banking sector (interviewed on 18 June 2009). In contrast, Edy Nofianto, Executive Director of PUSKOPSYAH DIY, expressed concern that the rapid development could lead to a 'bubble' situation and impair the sector's sustainability (interviewed on 28 May 2009).

When analysed using the credit union development framework (Ferguson and McKillop 2000), the fast-developing BMT sector in Yogyakarta can be categorised as being at the 'nascent' stage. In this stage, the BMTs are characteristically relatively small in asset size and offer traditional saving and loan products. The management of the institutions is influenced by the values of voluntarism and requires sponsorship from the government and/or external donor institutions. However, based on direct observation during the several periods of fieldwork, the pattern of rapid development of BMTs only occurred in the regions surrounding Yogyakarta city. In the major traditional markets, there are many microfinance providers such as commercial banks, microbanking units, rural banks, including BMTs, competing with each other to serve the traders and microenterprise clients. In this climate of keen market competition the small BMTs found it difficult to develop their market share against the domination of well-established BMTs and other competitors.

9.1.2. Key Financial Indicators in the BMT Sector

According to the Trade, DISPERINDAG-DIY, as of May 2009 (see Table 9.1.), the total assets of the BMT sector reached IDR 208 billion; on average each BMT managed approximately IDR 2 billion of assets and median assets of IDR 1 billion. Using a simple descriptive statistical analysis, there was a high disparity in assets among BMTs, of which the biggest BMT held IDR 25 billion in assets and in contrast, the smallest institution controlled assets of only IDR 0.03 billion.

The BMT assets comprise mainly loans, savings and deposits and capital. In terms of loan disbursement, and saving and deposit mobilisation, there was an approximate balance between lending and funding activities, since the total loans outstanding reached IDR 152 billion, and public funding was about IDR 155 billion. The survey by DISPERINDAG-DIY indicates that the BMT sector in this region was relatively self-funded and quite capable of performing its intermediary function as shown by a LDR ratio equivalent to 98.4 per cent. This LDR ratio suggests that the BMT sector performance is quite similar to the other community-based microfinance institutions such as the LPD sector in Bali (Arsyad 2006).

A more detailed analysis indicates that the well-established and large BMTs have a stronger liquidity position compared to their n3ewly-established counterparts. Although the member-sourced deposits of the BMT sector are not guaranteed by the government deposit insurance, the well-established institutions successfully accumulate substantial amounts of savings and deposits from the members, as the operations and reputation of the BMTs in the communities have been recognised for many years, thus, in return, they are trusted by the client members, especially those who are loyal savers. With strong and healthy financial performance, the institutions can expand their operational networks in different areas, increase their outreach and source more deposits from new members.

Conversely, newly-established BMTs that have not yet developed a reputation for trust and sustainability face a shortage of funding, and struggle to grow. To grow and sustain their operations, these institutions rely heavily on internal capital from their founders and external sources of funds. The common solution is for the infant BMTs to seek short-term loans from other BMT counterparts and offer high-return deposit schemes to special investors. However, eventually this short-term borrowing with high rates of return has the result that maintaining profitability and long-term sustainability is impossible.

In relation to disbursement of funds to borrowers, BMTs encounter somewhat less constraint they do in sourcing savings and deposits. As for the community-based microfinance institutions (Arsyad 2006; Budastra 2003; Holloh 2001), which have uncomplicated terms and conditions, streamlined procedures and the OVC methodology, the loans from BMTs are in high demand by client members. In addition, by granting very small amounts of credit, BMTs are able to target un-bankable borrowers who are not served by the commercial banks and larger microfinance institutions. As a result, the BMTs' direct competitors are moneylenders and other informal loan providers, hence there are opportunities to provide loans in the under-served villages and agriculture areas. And since the BMT model is based on Islamic principles and values and is a member-based microfinance institution, the majority of depositors and borrowers are eager to maintain a long-term relationship with BMTs.

In 2009, the profitability of the BMT sector in the DIY province was IDR 1.1 billion, with average net earnings per BMT of IDR 0.01 billion, and a median of IDR 0.07 billion. In addition, maximum and mini9mum values of profitability were IDR 0.2 billion and a loss of IDR 0.2 million respectively. Furthermore, by comparing the net profit with the total assets and earning assets (i.e. loan volume), it is revealed that the annual ratio of return on assets (ROA) was only 0.56 per cent and return on earning asset ratio was 4.64 per cent. From the perspective of commercial microfinance, the profitability of the BMT sector is far lower than rural banks (Parhusip and Seibel 2000), the BRI-Unit (Seibel 2004) and LPD (Arsyad 2006).

Due to limited information in the profit and loss reports, it is difficult to examine the underlying factors that determine the performance of the BMT sector in Yogyakarta. Nevertheless, there are four possible explanations for the level of profitability:

1. Normally the BMT institutions experience financial losses during the infancy stage because they only manage a small loan portfolio with limited economics of scale.
2. Productivity of the BMT assets, more specifically the net loan return, was low due to a small profit sharing margin between loans and deposits. As noted in the previous discussion, to develop member-based funding, the BMT institutions normally offer high rates of return on savings and deposits in order to compensate for the inherent risk of the BMT system, as the member-based funds are not covered by the government-deposit protection scheme.
3. There is inefficient asset allocation, as is shown by the discrepancy between ROA and return on earning asset (ROEA) of nearly 4 basis points, thus, in this perspective, the BMT balance sheet structure is not an ideal model due to the high level of fixed assets of BMTs.
4. Finally, the BMTs tend to have inefficient cost management processes to carry out the distinctive operational platform, especially in controlling overhead costs.

In brief, the overall BMT performance suggests positive signs of growth and performance of the financial intermediary function by a well-managed balance between savings and deposits, and loan disbursement (optimal loan-to-deposit ratio). Although the sector's profitability was comparably lower, the BMT sector produces a net profit that is capable of sustaining its operations.

The next section will examines selected BMT institutions concerning to what extent the faith-based microfinance model is financially viable and to how the institution sustains its operations, including an understanding of the influence of religious values and principles on the BMTs' performance.

9.2. Description of Selected BMTs

As stated in Chapter 4 (research methodology), this study employs the purposive sampling technique with the primary objective of examining the BMT sector with a focus on those that have been observed over three financial years (2008, 2009 and 2010). There are three main criteria used in selecting the unit of analysis.

The BMT should:

- be a member of the apex *Sharia* cooperative (PUSKOPSYAH),
- have conducted regular annual general meetings (AGM) in the last three years, and
- have submitted full financial reports in each of the three consecutive years.

9.2.1. Nature of Financial Report

As a cooperative microfinance institution, the performance of the BMT is examined on the basis of financial indicators such as the balance sheet, profit and loss, and other important performance figures that are presented in the regular monthly reports and/or annual reports (MENEGKOP-UKM 2008). The basic financial indicator and reporting systems use a best-practice cooperative microfinance accounting system, therefore theoretically the BMT should publish a standardised financial report and employ consistent accounting methodology. The MENEGKOP-UKM edict No35.3/per/M.KUKM/x/2007 also states that a cooperative microfinance organisation, including BMTs with over IDR 1 billion of total assets, should be audited by a public accountant.

In fact, the study found inconsistent practices because the majority of BMTs sampled published non-standard financial reports. This evidence indicates that BMTs are reluctant to adopt the standardised accounting and reporting system due to lack of qualified bookkeeping staff who understand the principles of the cooperative accounting policy. Similarly, only a few of the BMTs with total assets over IDR 1 million published audited financial reports as mandated by the edict. The common objection to the regulation was that the independent audit process was quite expensive and could not be afforded by the majority of the BMTs.

This situation was identified in Wahyuni's earlier study conducted in 2005 that found that out of 101 BMTs from 24 provinces, less than half of those published regular financial reports, and only 14 institutions were independently audited by external examiners (Wahyuni 2007). The study also emphasises that insufficient enforcement and regular supervision from the government has encouraged a negligence attitude on the part of BMT management in addressing good governance by providing financial accountability to the client members.

Because of the reporting deficiencies, the study encountered significant difficulties in conducting a thorough analysis of the BMTs, in particular to examine the critical factors that affect the aggregate BMTs' performance. As a result, to deal with that limitation, the analysis is clustered into three groups of BMTs based on age, total assets and location, as discussed in the following section.

9.2.2. Clusters of BMTs

Based on the criteria, 28 BMT institutions have been selected; the majority of those (82 per cent of the sample population) are located in the most populated areas and the centres of economic growth of the DIY province: Sleman district (11 BMTs), Bantul district (seven BMTs), and Yogyakarta municipality (five BMTs). In addition, another four BMTs operate in Kulon Progo district which has an agricultural background and rural-based economic activities. Overall, the units selected for analysis represent the pattern of the BMT network distribution in the Yogyakarta region. The matrix of the BMT sample is displayed in Table 9.2.

Table 9.2. Cluster of BMT samples (as of December 2010)

Indicator	Cluster	Geographical location (municipality/district)					Total	(%)
		Yogya-karta	Sleman	Bantul	Kulon Progo	Gunung Kidul		
Age	≤ 5 years	1	2	1	1	-	5	17.9
	6 – 10 years	2	2	5	-	-	9	32.1
	> 10 years	2	7	1	3	1	14	50.0
Sub-total		**5**	**11**	**7**	**4**	**1**	**28**	**100.0**
Asset	≤ IDR 5 billion	1	7	5	3	1	17	60.7
	IDR 6 – 10 billion	1	3	1	1	-	6	21.4
	> IDR 10 billion	3	1	1	-	-	5	17.9
Sub-total		**5**	**11**	**7**	**4**	**1**	**28**	**100.0**

Note: n = 28
Source: Data collected from field research 2009

Half of the BMTs in the sample have been in operation for over 10 years, having been established in between 1995 and 1999, and several of these BMTs were among the pioneers. They are well-recognised institutions with solid management and, more importantly, were institutions that were able to sustain their operations through the 1998 financial crisis.

The second cluster comprises nine BMTs that have been operating for between six and 10 years, but most of them were established in the early 2000s. These were typical of the second generation of BMTs that were established during the recovery period and were supported by PINBUK. The remaining group of five BMTs were established since 2005 during the growth period of the BMT sector. These institutions are modelled on the earlier BMTs and several of them have strong affiliations with the well-established BMTs.

9.2.3. Total Asset Performance

The BMTs manage a broad range of total assets. Average total assets were IDR 1.6 billion and the median value was IDR 3.6 billion. The range between the lowest and highest value was IDR 0.1 billion and IDR 40.7 billion. In order to eliminate the variability and also to simplify the analysis, the units for analysis were grouped into three clusters:

1. The smaller BMTs with total assets less than IDR 5 billion, which constitute 60.7 per cent of the sample BMTs.
2. The next cluster is mid-sized BMTs with total asset size between IDR 6 billion and 10 billion (21.4 per cent).

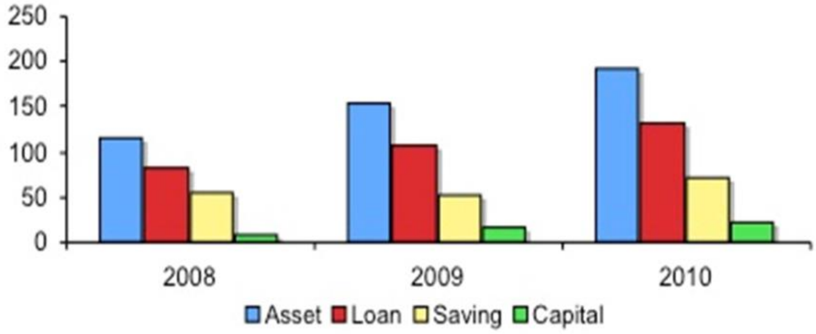
3. Finally, the larger BMTs with over IDR 10 billion (17.9 per cent) in total assets.

The matrix (Table 9.2.) demonstrates two important findings. Firstly, there is a causal association between location and size of assets. The figure suggests that all the larger BMTs (the big five BMTs) networks operate mainly in the urban and semi-urban areas of Yogyakarta (3), Sleman (1) and Bantul (1). Although these larger BMTs were established relatively recently their rapid development has been supported by the strong growth of the local economy in which they are located. Secondly, however, there is no significant correlation between the age and size of the business, as with the 14 BMTs established for over a decade, there are only three with more than IDR 10 billion in assets. Four of these older BMTs had assets of between IDR 5 -10 billion and the remaining seven BMTs had total assets of less than IDR 5 billion. Some of these older and smaller BMTs operate in rural areas where the seasonal and low cash flow nature of the economy limits their potential growth, but they have nevertheless continued to provide financial services to their members in a sustainable manner.

These findings are similar to those from a previous study that identified that the age of the operation is not an important determining factor of the microfinance lender's performance (Ayayi and Sene 2010). Instead, the growth and financially viable of the BMTs is influenced by the capacities, skills and resources of the founder and supporters, management and staff (see Chapter 8).

In the most recent years, BMTs have demonstrated strong performance as the business volumes continuously expand. In the financial year of 2010, the total asset volume has nearly doubled as the net asset growth reached IDR 80 billion compared to the figure for 2008. In addition, on a year-on-year analysis, the expansion of the BMT business amounted to approximately IDR 37.6 billion in 2009 and steadily grew approximately IDR 42.5 billion so that by the end of 2010 total assets stood at nearly IDR 199 billion. In relative percentage terms, however, the figures suggest a declining rate of growth from 31.6 per cent in 2009 to 27.2 per cent in 2010. The general BMT asset development is displayed in Figure 9.1.

Figure 9.1. Financial Structure of BMT Institutions



Source: Calculation based on the financial reports of the BMTs surveyed

As previously mentioned, it is quite difficult to understand the specific nature of BMT development through a two-year period of observation. Also, from another point of analysis, the success of the top-five dominant BMTs substantially distorts the picture of the BMT sector as whole. In the last two years, the total assets of these large BMTs rose steadily from IDR 58.9 billion to 109.1 billion. In other words, the net growth amounted to IDR 50 billion, or on average, the assets increased IDR 25 billion per annum. Indeed, nearly half of the net assets of the largest five BMTs occurred in just one BMT, while the remaining BMTs contributed to a fairly equal growth rate, on average IDR 6.4 billion.

It is obvious that being the pioneer and the largest BMTs in the region, and having a high reputation as one of the most successful BMTs in Indonesia, the institution also has advantages in attracting savings and deposits, as well as soft loans from the government. With diverse funding resources, BMTs with a broad service outreach in new locations have a capacity to increase their average loan value to their clients. Equally important during the recovery period, this institution disbursed huge amounts of concessional loans to microenterprises that were affected by the disaster.

By age of establishment, the figure suggests that the oldest BMTs (over 10 years old) recorded the most rapid rate of asset growth (in distinction to the size of their assets), of approximately IDR 56.7 billion. However, out of the 14 BMTs, the high rate of asset growth was mainly influenced by the outstanding performance of the biggest BMT. When the largest BMT is excluded from the analysis, it seems that only two BMTs recorded asset growth of over IDR 5 billion, while the remaining BMTs experienced quite modest growth of roughly IDR 1.8 billion. This evidence clearly supports the previous finding that there is no significant correlation between the age of the BMT and better asset performance (Ayayi and Sene 2010). Furthermore, the group of younger BMTs (between 6–10 years old) accumulated assets of nearly IDR 15.3 billion, but within this cluster there was only one BMT that recorded substantial asset growth of more than IDR 7 billion. The other BMTs experienced modest growth, on average IDR 0.9 billion. In addition, the youngest counterpart group (age of five years) had a similar pattern of growth, in which out of the five BMTs only one recorded significant asset growth, from IDR 4.9 billion in 2008 to IDR 10.7 billion in 2010. On average, the remaining BMTs in this cluster increased their asset volume by IDR 0.5 billion.

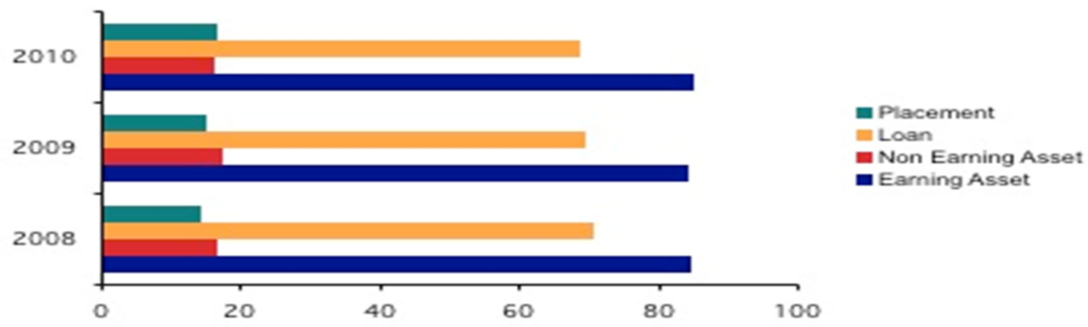
In relation to geographic location, BMTs in Yogyakarta city shared the highest asset growth, in total increasing by IDR 38.6 billion or on average IDR 7.7 billion. This progressive expansion was primarily because of the direct contribution of the three largest BMTs. In Sleman district, the total assets of the BMTs climbed by IDR 12.4 billion from IDR 40.0 in 2008 to IDR 61.1 billion in 2009. Among the Sleman BMTs, there were four BMTs that recorded asset growth between IDR 2.7 billion and IDR 5.2 billion, whilst another seven institutions only grew by less than IDR 1 billion. In Bantul regency, the BMT cluster suggested wide variation in business performance. The highest growth was achieved by one BMT that recorded additional assets of IDR 7.8 billion, then was followed by three BMTs with total asset increase over IDR 1 billion, and the other two BMTs grew less than IDR 1 billion. In the following districts – Kulon Progo and Gunung Kidul – the average total asset growth reached IDR 1.3 billion.

In summary, although there is a huge variability in the BMTs' performance, it is important to reiterate that overall the BMTs showed positive development over the last three years. According to several BMT managers, for example Edy Nofianto, Executive Director of PUSKOPSYAH DIY, the BMT sector in Yogyakarta has just recovered from the severe financial turbulence due to the earthquake disaster in mid-2006. He notes that since 2008 the sector has reached optimal performance, and in particular, the leading BMTs have demonstrated steady business expansion during the recovery period (interviewed on 28 May 2009). The following analysis examines the financial performance of BMTs and, more importantly, identifies and analyses the critical factors that affect the sustainability of the BMTs.

9.2.4. Financial Asset Allocation

Generally speaking, the primary function of the BMT system is to act as a financial intermediary accommodating the different needs of its depositor and borrower members. In practice, BMTs source funds from the members and other sources, and subsequently they allocate the funds into earning assets like loan disbursements, placement in banks and other financial institutions, and other return-generating investments in the real economy. In the last three years, the total of outstanding earning assets showed steady upward growth from IDR 101.2 billion in 2008 to IDR 168.4 in 2010, or an increase of IDR 67.2 billion. This pattern of growth was parallel to the expansion of assets.

Figure 9.2. Composition of Financial Asset



Source: Calculation based on the financial reports of the BMTs surveyed

Theoretically, any financial institution would employ its resources so as to generate maximum return. As illustrated in Figure 9.2., the total earning assets of BMTs have been consistent at over three quarters of the total assets. In 2008, they were 85.1 per cent, rose marginally to 85.3 per cent in 2009, and then slipped down to 84.6 per cent. There are several critical factors that influence the dynamic change of earning asset proportion that is related to the lending disbursement and funding mobilisation. This issue is discussed in the following Section 9.3.

In addition to return-generating assets, the remaining resources of BMTs are allocated in zero-interest-bearing investments and other non-earning assets such as office buildings, furniture, computers, supplies and other inventories to support their operations. The main non-earning asset components are cash in safe deposit and fixed assets. In spite of the amount of assets classified as unproductive, physical cash is very important for the management of liquidity. In this regard, BMTs should maintain a minimum cash ratio in order to provide sufficient funds for daily saving, deposit and loan transactions.

In contrast to the transitional funds in bank placement accounts, cash is ready physical money that should be kept in the safe deposit. Typically, the cash reserve is higher during the seasonal periods. The BMT clients save so they have income available for future needs, such as those already mentioned, mainly to celebrate Ramadhan, and *Ied al fitr* and *Ied al qurban* festivals, as well as in July and January to pay school fees for the semester periods.

Consequently, in the peak seasons, the demand for loans also increases as well as the business activities doubling compared to the remainder of the year. Indeed, it is imperative for BMTs to retain sufficient cash reserves when it is needed, otherwise, if a shortage occurs, the BMTs may lose the trust and confidence of clients; they could perceive unsatisfactory access to cash as a sign of financial deficiency and eventually lead to a run on the institution.

In general, according to the cooperative regulations and the PIBUK guidelines, the ideal cash ratio (amount of daily cash in the safe deposit) between 2 - 6 per cent of the total public fund (saving and term deposit); In this context, the more cash that is invested in productive assets, the better. Technically speaking, BMTs employ different cash management strategies, in particular regarding the amount of daily cash in the safe deposit. Some BMTs hold between 10 and 20 per cent of current liabilities and it would be increased to more than 30 per cent during busy periods. The BMTs located in the city centre maintain lower cash reserves since they could easily withdraw from their bank placement accounts when needed. In contrast, BMTs operating in remote areas would keep higher cash reserves. In effect, these BMTs in remote areas would bear higher cost of funds than their counter parts in the city centre.

BMTs also need physical infrastructure to support their operations in the community. Office property, vehicles and other equipment are essential for the institution to be successful. However, it must be noted that a high investment in fixed assets can lead to inefficiency. Being a local and independent microfinance organisation, the BMTs require a high profile to attract investors, depositors and borrowers as client members.

Arguably, for this reason the BMTs are inclined to invest significant funds in elegant office buildings. Yet, as a valuable asset, the office property can be used as collateral for obtaining additional liquidity from banks and inter-borrowing facility from other BMTs. Field observations suggest that the majority of leading BMTs own their office buildings and nearly all BMT founders and management recognise that physical infrastructure generates a good image in the eyes of member clients, investors and other stakeholders in the community.

BMTs are likely to maximise their financial asset allocation into highly productive investments in order to gain maximum return on them. However, to manage the assets in general – and more specifically the earning asset portfolio – the institutions should also manage their non-earning assets in an efficient way in order to enhance the operation with minimum opportunity loss. In other words, the more efficient the asset allocation is, the more the BMTs will generate better profitability and financial sustainability.

9.3. Financial Intermediary Mechanism

The basic principle of the BMT system is to carry out a financial intermediary function that is based on the Islamic microfinance approach which strictly prohibits interest-based, speculative, exploitative, and other unlawful transactions (see Chapter 2). For these reasons, the BMT model and financial arrangements are different from the conventional counterparty.

As noted earlier, the core principle of the BMT operation is to mobilise funding in term saving, deposit and borrowing from other institutions, and subsequently to invest those funds into productive economic activities, primarily to finance microenterprises and low-income households. In addition to the basic financial transactions, it is common for BMTs to conduct other financial transactions to accommodate members and non-member clients, including providing bill payment and remittance services. This section discusses the mechanisms of negotiating the funding and lending activities of BMTs, and more importantly to assess the funding and loan portfolios with regard to what extent the distinctive financial methodology influences the sustainability of the BMT performance.

9.3.1. Funding and Capital Mobilisation

According to the Cooperatives Law No: 25/1992 and the MENEGKOP-UKM Decrees (No: 91/Kep/M.KUKM/IX/2004 regarding KJKS/UJKS and No: 35.2/Per/M.KUKM/X/2007 regarding the standard operating procedure of KJKS/UJKS, BMTs are only allowed to source savings and deposits from their client members. It is clear that this requirement for financial cooperatives means that BMTs are not permitted to attract funding from non-members in the community, however, they are permitted to borrow from other financial institutions such as BMT counterparts, Islamic banks, venture capitalists and government agencies. In effect, the policy allows the institution to diversify their sources of funds and to maintain sufficient liquidity to expand lending. In this regard, a diverse source of funds is a critical factor influencing the success and sustainability of the institutions (Robinson 2001).

9.3.1.1. Saving and Deposit

A member-based microfinance institution such as BMT commonly provides two types of saving and deposit accounts: firstly, a compulsory saving account that is related to ownership and membership of the BMT (see discussion in sub-section 9.2.3.3) and secondly, a voluntary saving and deposit account. The most popular voluntary saving and deposit are passbook saving and time deposit accounts. These products vary among BMTs but the basic features are similar to the Islamic banking products. As for BPRS, BMT is not a part of the national payment system hence, it is prohibited to offer checking accounts and foreign exchange accounts. Interestingly, the restriction does not confine BMTs to developing only saving and deposit products, and to some extent the BMTs have been very innovative in attracting members through their offering of diverse products and services.

Table 9.3. Description of BMT Saving and Deposit Instruments

Product	**Basic Attributes**
Term Deposit (TM); the generic name is *Deposito Mudaraba*	Term deposit is based on PLS transaction (*mudaraba*). TM are offered for periods of 3, 6, 12 and 24 months, and every term has a different ratio of return – the longer the period, the higher the rate of return. The minimum TM is usually IDR 500 thousand; higher amounts attract a better rate of return. Average rate of return for depositors is in the range of 20–30 per cent, and the rest for the BMT institution.
Passbook Saving (PS); the generic name is *Tabungan Mudaraba*. There are several types of passbook saving accounts: *Tabungan Pendidikan*, *Tabungan Haji*, *Tabungan Qurban* and *Tabungan Hari Tua*	Typical passbook saving accounts are based on PLS (*mudaraba*) and trust (*wadia*). Withdrawals can be made from PS any time; the initial amount and further deposits can be as low as IDR 5000; there is no monthly administration fee. The rate of return for passbook savers is very low, on average 5–10 per cent. Several BMT institutions offer prizes and incentives for loyal savers.

Source: Brochures and leaflets of several BMT Institutions

Unlike BUS/UUS and BPRS which are very competitive in attracting public saving through their widespread office networks, extensive marketing campaigns and protection through the government deposit insurance scheme (LPS), voluntary funding of the BMT sector relies on local businesses and individual members. Thus, to counteract the network limitations and lack of deposit insurance protection – including fierce competition from the banking sector – BMTs generally employ a niche marketing strategy by offering saving and deposit products reflecting local socioeconomic conditions and suitable to the clients' preferences and particular needs.

BMTs use micro marketing techniques by involving prominent local clerics and community patrons to attract new members and deposit funds. The presence of influential Muslim figures serves to boost the confidence of depositors concerning the security of their deposits, despite the fact that there is no guarantee from the government's deposit insurance. In addition, as discussed in Chapter 8, BMTs use personalised techniques through establishing close relationships with the depositors, and providing excellent services to the customers at their homes or businesses (OVC). Technically speaking, the OVC procedure is very simple. During business hours, the BMT manager or marketing officer conducts regular visits to existing or prospective clients who intend to deposit, withdraw or open a saving account. Usually the BMT clients are both depositors and borrowers, and so the officer disburses loans and collects repayment instalments from the same people.

Besides the regular OVC, BMTs are also used on an on-call basis for prime clients who deposit substantial amounts of money (i.e. over IDR 5 million). This approach is greatly appreciated by the depositors because it is very convenient, secure, saves time and has low transaction costs, especially for clients who are unable to come to the BMT office during business hours. According to Joni, the manager of BMT MUI, from the perspective of BMTs the OVC strategy is a very effective tool to transact public funding in the community and also especially successful in competing with the commercial banks (interviewed on 3 July 2009). Apparently, the OVC approach has been adopted from other community-based microfinance institutions such as the LPD Bali (Arsyad 2006) and cooperative institutions in Lombok (Budastra 2003).

Islamic organisations like community mosques, foundations, boarding schools (*Pesantren*) and socio-religious rotating saving groups (ROSCA, Rotating Saving and Credit Association, or *Arisan*) are also important funding sources of BMTs. It is relatively easy for the BMTs, as Islamic-affiliated microfinance institutions, to establish mutual relationships and gain funding support from these religious-based organisations. ROSCA has been a very popular informal means of saving in the local community. People deposit money in a pooling system and each member then withdraws the full amount of her/his saving at certain period. While the *Arisan* saving group operates, a BMT acts as an institution of safe deposit for the funds. In the field study area there were many *Arisan* groups involving significant numbers of households. The funds accumulated through the *Arisan* groups are an important source of deposits for the BMTs.

In addition to provide better services and very close personal relationships, an equally important feature is that BMTs also offer saving and deposit returns[110] slightly higher than that of the competitors. This strategy is used especially to increase long-term funding and attract risk-adverse clients who seek high investment returns, particularly since the BMTs are not covered by the government’s deposit insurance.

Over three consecutive years, the saving and deposit holdings of BMTs recorded significant growth from IDR80.7 billion in 2008 to IDR 128.6 billion at the end of

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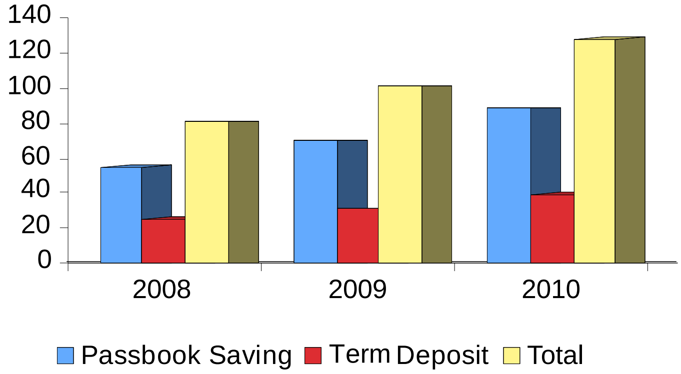
[110] Islamic banking principle prohibits interest that can be generated from lending money and unlawful financial transactions. Instead, Islamic banking allows return or profit which can be obtained from business partnerships, trade and other permissible financial transactions (see discussion in Chapter 2).

2010. It increased by nearly IDR 47.8 billion or 59.3 per cent. In particular, when the figure is broken down, it is revealed that passbook saving rose to IDR 33.8 billion (61.1 per cent) and term deposits increased by nearly IDR 14.1 billion or 55.6 per cent. Moreover, a detailed analysis reveals that the composition of BMT funding is dominated by passbook savings which amounted to 69.3 per cent, while term deposits were 30.7 per cent. Indeed, the funding structure is the key factor that influences the BMTs' capacity to provide loans, the costs of their loans and overall profitability. As a consequence of the BMTs' dependence on passbook savings accounts, they have to focus on short-term loans since passbook savings are high-transaction accounts. However, these accounts have the advantage of being a low-cost of source of funds compared to term deposits that offer higher returns to the depositors (see discussion in Section 9.4.).

With respect to the size of BMTs, the five largest BMTs mobilised much greater savings and deposits; in particular one BMT accounted for the highest holdings of IDR 25.5 billion in 2010. On average this cluster of BMTs managed approximately IDR 12.8 billion. The middle-sized BMTs on average reported IDR 5.8 billion of member-based funds. The group of smaller BMTs handled smaller saving and deposit funds, on average reporting IDR 1.7 billion. This figure clearly shows a strong relationship between the size of the BMT and funding mobilisation capability. The big BMTs manage a more extensive office network and marketing staff and they are able to serve client members in different regions. In addition, these BMTs are well known and have good reputations in the community. They attract more affluent savers and depositors to invest significant funds.

Figure 9.3. Voluntary Savings and Deposits



Source: Calculation based on the financial reports of the BMTs surveyed

The analysis suggests that the cluster of oldest BMTs recorded better saving and deposit holdings. Within the group, there was very wide variation of funding mobilisation capability from one BMT to another; on average the volume of saving and deposit was approximately IDR 6.1 billion. The cluster of newer BMTs, on average, accounted for IDR 3.6 billion and IDR 2.3 IDR respectively. Similar to the previous finding, the older BMTs had been able to establish reputations as respectable and trusted microfinance institutions.

Within the region, BMTs in the Yogyakarta city attracted the largest member-based funds total compared with the other BMTs in the neighbouring districts of Sleman, Bantul and Kulon Progo. As noted in the earlier analysis, the structure of the local economy significantly influences the performance of BMTs. Yogyakarta city is the main centre of business and money circulation in the province and it provides the best funding opportunity for BMTs compared to other regions.

9.3.1.2. External Funding

Despite being local microfinance institutions, the BMT sector has been a sub-system of the banking and finance industry. In this context, BMTs are allowed to obtain external funding in addition to member-based savings and deposits. To some extent, as a community-based microfinance institution, many BMTs encounter shortages of funds and struggle to manage their liquidity from time to time. As discussed above, the most common liquidity problem is during the seasonal religious festivals and at the time for new school enrolments. At these times there are massive withdraws of savings and deposits that lead BMTs into a temporal liquidity crisis. This high seasonal demand for cash is usually three times the normal level of demand, both to satisfy the withdrawals and to continue disbursing loans.

As already mentioned, the sources of borrowing of the BMTs include Islamic banks, other BMTs, venture capitalists and government agencies. There are several models of fund borrowing in the BMT sector (Antonio 2004):

1. The linkage scheme between BMTs and the Islamic banks. In general, this mechanism is adopted from linkage programs between BUS/UUS and BPRS. However, given that the BMTs are not regulated and supervised by the central bank and the BMT business model involves higher credit risk, there are some modifications, especially in the selection procedure. For instance, the banks employ prudential credit policy to assess the financial viability, track record and future prospects of the BMT, including the provision of additional physical collateral to secure the risk of default. The linkage contract uses the PLS system and a commercial rate of return; 70 per cent profit for the BMT and 30 per cent for the bank is common. However, due to the robust requirements, the linkage program is not a perfect solution to solve the liquidity problem, especially for new and growing BMTs.
2. Inter-borrowing between BMTs takes place. The basic principle here follows the interbank money market where an over-liquid BMT lends the funds to another BMT in order to fill the liquidity gap. The fund placement arrangement is carried out via direct financing between the BMTs and/or through indirect financing arranged through PUSKOPSYAH. The inter-lending contract uses the PLS system and the proportion of return based on the market rate benchmark, for example, between 70:30 and 80:20. The BMT inter-lending mechanism generates advantages for the sector because it helps over-liquid BMTs to maximise their return by lending idle funds into earning assets. For the other BMT, the borrowing scheme eases the temporary liquidity problem. However, since the size and funding capacity of the BMT sector is very small, the BMT inter-lending system is not sufficient to meet the demand for cash, in particular during peak periods. Recently, the inter-borrowing model has been expanded through BPRS. The idea behind this approach is to use BPRS as a means to mobilise public funds (saving and deposit) and to take

advantage of the deposit insurance provision (LPS). Since the LPS guarantee the saving and deposit accounts, the BPRS is seen as a secure financial institution and as such it attracts savers, especially institutional clients.[111] The mobilised funds can then be lent to BMTs. There are two BPRS owned by a consortium of BMT institutions. Theoretically, this strategy seems quite feasible, but in practice it faces legal lending limit regulations, which limit the capacity of BPRS to finance BMTs.

3. The venture capitalist, PBMT obtains commercial funds from private investors as well as from the Islamic banks. Subsequently the funds are lent to the BMT institutions under the full commercial PLS contract. Recently, the capacity of PBMT has been gradually increased and it has become one of the major sources of liquidity for BMTs (see also Chapter 7).
4. The government concessional loan scheme is channelled through two government-owned agencies: LPDB channels the *Sharia* revolving funds (DBS-KUKM), and PNM manages the government bonds (SUP-005). The LPDB distributes funds through the Islamic banks and the apex cooperatives that lend funds to support the liquidity of the BMT sector. Lately, LPDB has expanded the program through venture capitalists and direct financing to well-established BMTs in order to reach more BMT institutions. According to Halomoan Tamba, Business Director at LPDB, typically the LPDB provides long-term financing and employs the PLS system, but the rate of return is far below the market rate (equivalent to the 3-month Bank Indonesia interest rate, or 6 per cent). Since LPDB manages the government revolving fund, the financing procedure is akin to general banking practices and uses the BMT capital as the gearing ratio to determine the funds that can be provided. In the BMT case, LPDB sets a gearing ratio of 10 times; that means that the BMT institution could receive maximum financing of 10 times its capital, or a debt–equity ratio (DER) of 10 per cent (interviewed on 16 May 2010). The LPDB soft financing scheme is in high demand by the BMT sector, however the capacity of LPDB to engage with the BMT institutions is very limited because its smaller network and lack of human resources. The later model is extended by PNM to the apex cooperative institution (the INKOPSYAH linkage). Arison, Director of

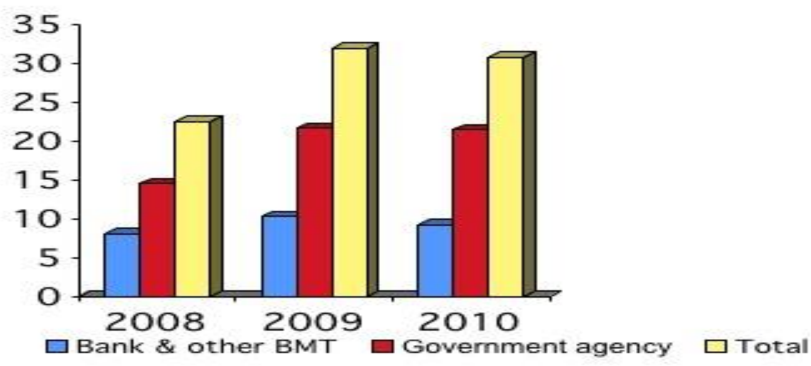
[111] In the beginning, Muhamadiyah allowed its units to put their funds into the BMT institutions as a commitment to this Islamic organisation in support of the BMT movement. Following several insolvency cases in the BMT sector, Muhamadiyah has changed its policy by depositing funds into the formal banking institutions, including BPRS.

INKOPSYAH, notes that the SUP-005 is designed as a two-step financing model, with a rate of equivalent return of approximately 20 per cent per annum. Of the calculated return, 6 per cent is remitted to the government (equal to the three-month Bank Indonesia interest rate), while PNM and INKOPSYAH receive 4 per cent and 10 per cent respectively (interviewed on 23 August 2009).

Over the past few years, the total BMT outstanding borrowings demonstrated quite substantial growth from IDR 23.1 billion in 2008 to IDR 31.9 billion, or the equivalent of 27.7 per cent. The growth was predominantly influenced by a significant increase in the LPDB concession fund, from IDR 14.6 billion in 2008 to IDR 21.5 billion in 2010, compared to the linkage-borrowing program that was increased by only IDR 1.9 billion. Quite interestingly, although the size of external borrowings increased, in contrast its share of total liabilities decreased from 18.9 per cent to 16.6 per cent. It seems that the intense increase of savings and deposits has affected the downward trend in external borrowing, especially from the commercial linkage fund from the Islamic banks.

Basically, the declining contribution of commercial borrowing in liabilities might have two possible implications for the performance of BMTs. First, it would improve long-term competitiveness, i.e. bring about a better loan-to-deposit ratio (LDR), and reduce the cost of funds, as the return on saving and deposit accounts are far lower than the rates for external borrowing.

Figure 9.4. The BMT Borrowing Scheme



Source: Calculation based on the financial reports of the BMTs surveyed

The BMT group with the greatest assets borrowed more – on average IDR 3.9 billion, in particular concession loans from the government agencies. It was followed by the middle-sized BMT groups where the average amount borrowed was IDR 0.6 billion, and then the small-sized BMTs that on average accounted for IDR 0.5 billion of external borrowing funds. There are two interrelated issues relating to why the borrowing account of the top-tier BMTs increased quite sharply. First, the concession loans are a long-term lending facility and typically low cost, as the price is below the market rate, therefore the fund seems more attractive than commercial borrowing from the Islamic banks. Secondly, since 2009 there has been a new regulation for the concession fund procedure that allows the well-established BMTs, in particular those possessing a robust capital structure, to receive direct financing from LPDB. Clearly the policy change would allow the top BMT group to obtain substantial concession funds rather than going through the usual two-step financing mechanism and the linked program.

The oldest BMTs borrowed more funds from external sources, on average IDR 1.6 billion, compared to the other BMT groups which accounted, on average, for IDR 0.7 billion and IDR 0.6 billion respectively. Furthermore, BMTs in Yogyakarta city received more funds as the majority of the large-sized BMTs operate in that region.

9.3.1.3. Capital Structure

The capital structure of BMTs consists of core capital, reserve and retained earnings. Since by law the status of a BMT is categorised as a *Sharia* financial cooperative, its institutional arrangement is similar to that of the generic cooperative. As described in Chapter 8, one of essential requirements of BMTs is core capital that should be provided by founders and members. The BMT capital is categorised as a compulsory saving account (CSA) that comprises two basic accounts (*Simpanan Pokok* and *Simpanan Wajib*). The CSA is the subscription paid by new members and the capital is permanently kept on the balance sheet of each BMT, as it can only be withdrawn when a member resigns from the BMT.

The terms and conditions of the CSA are stated in the BMT Charter; the amount is fixed for each membership and it entitles an equal voting right at the AGM (one membership, one vote). The amount of the CSA is flexible and varies among BMTs because it depends upon the individual BMT Charter (AD and ART). The PINBUK guidelines of BMTs dictate that the founders make more substantial CSA contributions than ordinary members (Aziz 2004). In practice, the CSA requirement is based on a general assessment of the domestic economic capacity of the local inhabitants. Since the majority members of BMT are micro-entrepreneurs, self-employed and lower-income individuals, hence the BMTs set a minimum CSA amount between IDR 100 and IDR 500 thousand.

In addition, many BMTs allow the members to pay the CSA subscription in several instalments during the temporary membership period. In the field study it was found that some BMTs offered pre-paid CSA for new memberships in order to expand the membership and to promote the BMT's services in the community.

Besides the CSA, a BMT is also allowed to offer special saving accounts (*Simpanan Pokok Khusus*). These accounts are designed to accommodate members who are intending to make a long-term investment in the BMT. As a mode of investment this account does not give voting rights to the account holders and can be withdrawn or reinvested when it is due (see also discussion in Section 8.2.8. Membership System).

Table 9.4. Attribute of Compulsory Saving

Product	Basic attributes
Simpanan Pokok (SP) *Simpanan Wajib* (SW) *Simpanan Pokok Khusus* (SPK).	SP and SW are frozen saving accounts that are calculated as shares (capital) in the BMT institutions. An initial amount of SP and SW between IDR 100 thousand and 1 million depends upon the BMT institutions' charter (AD and ART). SPK is a long-term investment account (partnership) that can be withdrawn and reinvested when it is due, or as agreed. SP, SW and SPK entitle the holder to returns from annual profit after tax and compulsory donations (SHU) that are paid annually. However, in case the BMT institution experiences loss, SP, SW and SPK will be used to cover the loss.

Source: MENEGKOP-UKM regulations, and documentation of AD/ART of BMTs surveyed.

Furthermore, BMTs are permitted to receive capital grants and donations from external parties including individuals, institutions and government. The rationale of this policy reflects the fact that most BMT members have limited economic capacity and these capital grants provide alternative funds for the BMTs to strengthen the capital structure without being an additional burden on the members. In recent years, the local (provincial and district) governments have provided additional capital to the BMTs, especially in the aftermath of the earthquake in 2006. The objective of the donated funds was to cover the

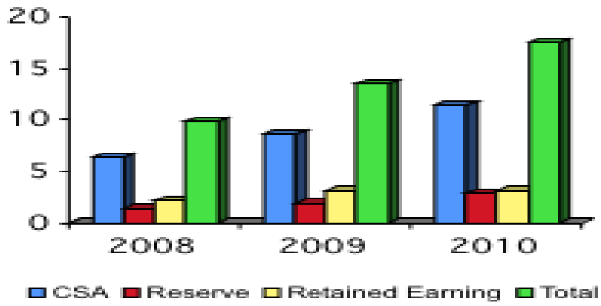
BMTs’ losses due to massive loan defaults, and to re-establish the BMTs’ infrastructure, mainly their office buildings. The grants allocated depended upon the budget of the local governments and the location of the BMTs in relationship to the earthquake. The average grant was IDR 50 million. In some cases, the capital grant was related to the political interests of the incumbent administration, in particular to maintain their popularity for the next election campaign. Some of the respondents in this research suspected that the allocation of these recovery grants funds was not a fair and transparent process, with grants channelled to particular BMTs with links to influential members of the elite and prominent local organisations.

Adequate capital is an essential requirement for BMTs to grow and become sustainable. Based on the MENEGKOP-UKM regulations, the capital performance of BMTs is measured through the capital adequacy ratio (CAR) – the percentage of capital to total risk-weighted assets. In this respect, a financially healthy BMT should maintain a minimum CAR of approximately 8 per cent; this ratio benchmark is adopted from the banking industry. In the microfinance sector, capital sufficiency is a reflection of the capacity to cover any losses and the sustainability of the institution. Technically speaking, adequate capital held by the BMT institution generates several advantages including easier access to external borrowing. More importantly, the example of the LPD in Bali suggests that a robust capital structure and strong performance builds an institution highly regarded by the client members and investors (Arsyad 2006).

During the period of study, the capital of the BMTs in the research sample grew from IDR 9.7 billion in 2008 to 17.5 billion in 2010. The capital structure of these BMTs consisted of CSA of 65.1 per cent, reserve 16.0 per cent and retained earnings 18.9 per cent. The main factor contributing to this capital expansion was the sharp increase in CSA volume, which rose over IDR 5.1 billion or 80.1 per cent. The performance of the CAR also improved from 9.3 per cent to 10.5 per cent. This figure was above the minimum requirement as stated in the MENEGKOP-UKM requirement.

The substantial increase in CSA reflected the growth in membership, in particular related to the business expansion of BMTs. Also, in the last few years the BMT managements have been endeavouring to enhance the capital structure by obtaining concession funds from the government (see discussion in Section 9.2.3.2). BMTs have also sought to encourage existing members to increase their CSA contributions and have also offered affluent members special investment accounts with attractive annual returns. Some BMTs increased the reserve and retained earnings by gradually reducing the annual dividend to the members and bonuses for management and the supervisory boards.

Figure 9.5. Capital Structure of BMT



Source: Calculation based on the financial reports of the BMTs surveyed

In a detailed comparative analysis, in 2010 the top-tier BMTs by asset size had larger amounts of capital, on average IDR 1.6 billion. The middle-sized BMT cluster reported an average of IDR 0.6 billion, and the small BMTs had IDR 0.3 billion in capital, on average. Likewise, the oldest BMTs recorded higher average amounts of capital compared to the younger BMTs. Based on region, BMTs in Yogyakarta city had a stronger capital structure, on average IDR 1.0 billion, followed by the BMTs in Bantul district with an average capital of IDR 0.7 billion, while those BMTs in Sleman and Kulon Progo districts had, on average, IDR 0.5 and IDR 0.2 billion in capital, respectively.

In summary, the BMTs had a diverse range of liquidity instruments as they mobilised funds from different sources. The voluntary saving and deposit services are the most important source of funding that can be channelled into loans and other productive portfolios. The passbook saving accounts tend to be small in size and have a relatively low return, but the turnover increases significantly at particular times of the year when members have greater cash requirements. However, as financial cooperative microfinance institutions, the provision of saving and deposit services is restricted to client members only, with the consequence that BMTs often experience a shortage of funds to expand the business. Furthermore, to compensate for liquidity shortages, BMTs rely upon external borrowings from Islamic commercial banks, government agencies and other financial bodies. Concessional borrowing from government agencies like LPDB is the most favourable option because the fund involves lower costs and can provide long-term loans. In addition to the above funding sources, capital is very important for the operation and growth of BMTs, in particular for CSAs. Strong capital structure and CAR performance are not only able to cover potential losses but are important to attract more depositors and lenders and build financial viability.

9.3.2. Loan Disbursement and Performance

According to the majority of BMT managers and loan officers, lending or financing is the main source of income in the earning asset portfolio of BMTs (FGD on 20/08/2009 in Yogyakarta). The basic lending methodology of BMTs is quite uniform and straightforward; to some extent it is similar to the general microcredit practices (Nelson et al. 1996; Robinson 2002; Yunus and Jolis 1999). In addition, from the field research, it reveals several underlying factors that could explain the BMT lending model and practices.

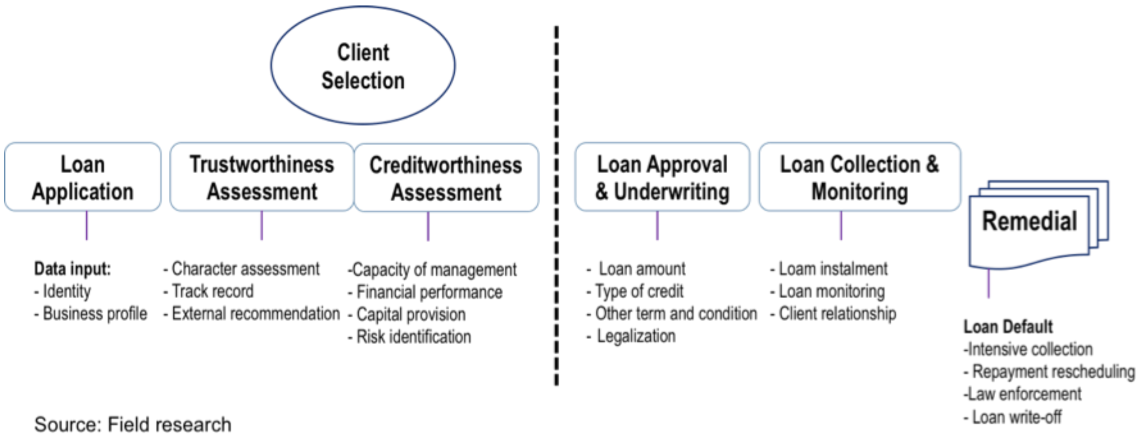
1. The most common types of loans are individual and group lending methodologies. BMTs mainly provide individual loan facilities to individual client members based on their individual performance and capacity assessment and screening. Under the individual lending scheme, clients are responsible for repayment, loan default and other financial and legal consequences.
2. The individual lending model is very familiar to the majority of clients and many microfinance institutions have practised it because it is quite straightforward. However, some BMTs, like BMT-Kube (PINBUK model), use the group lending approach to provide finance for client members. This is adopted from the Grameen Bank’s practice that emphasises group formation, compulsory training, mutual interest and cohesion among the members within the group. The model stresses collective responsibility for loan repayments and other financial liabilities, if any member defaults on the loan. This mode is suitable mainly for the poverty alleviation projects by targeting the poorer clients, those who are self-employed or operating start-up microenterprises.

3. The characteristic loan is for a small amount and for short-term financing. The vast majority of BMT loans are for amounts in the range of IDR 500 thousand to IDR 5 million, far below the average loan size in microbanking. This low-scale financing reflects the typical profile of client members and the internal capacity of BMTs to provide funding and assume risk. However, some of the well-established BMTs have gradually increased the size of loans to accommodate particular clients as their business develops. In addition, due to the distinctive characteristics of the clients and the BMTs' limited funding capacity, the loan facilities are mostly focused on a short-term business cycle in the range of 1–12 months, and structured into different loan repayment schedules: daily, weekly and monthly. In most cases, small loans are repaid according to daily, weekly and monthly repayment schedules. Larger loans are repaid over longer periods with monthly instalments.
4. The target market is microbusinesses with a quick turnover and high profitability. As previously mentioned, BMTs focus on petty traders in the community market places as their main borrowers. Normally, the trading activities in the traditional markets are based on daily transactions and related to basic household needs including food commodities and durable goods. Thus, the businesses turnover of the BMT clients is quick and very liquid (cash oriented). In this respect, the rapid trading cycle generates substantial profit that enables loan repayments to BMTs.
5. The lending procedure is designed to be streamlined and have low transactional costs. As mentioned earlier, the typical BMT clients are petty traders, therefore the financing process is designed to be as simple as possible. The simple procedures and OVC approach allow BMTs to reduce administrative paperwork and simultaneously speed up loan disbursement. In return, the streamlined financing arrangements maintain control over the overall transaction cost; it is less time-consuming and has low direct administration costs both for BMTs and for the clients.
6. Finally, the most common financing instrument of BMTs is non-interest-based loans under a partnership contract (*Mudaraba* and *Musaraka*), and mark-up (*Murabaha*) and leasing arrangements (*Ijara*). Although regarded as less important sources of income, some BMTs provide a benevolent loan scheme (*Qard al Hasana*) to finance poor client members and/or ordinary clients who are facing difficult situations.

9.3.2.1. Loan Policy and Process

Rama Widia (Manager of BMT Al Ikhwan) states that as a financial intermediary institution, the main activity of a BMT is to invest the clients' funds into productive and socioeconomically profitable businesses, hence the financing process is carried out under the prudential lending principle (interviewed on 23 July 2009). In this respect, the lending model of BMT is related to the risk of default (Bourke and Shanmugam 1992). In general, Maya (Manager of BMT Beringharjo) explains the BMT loan procedure involves the following stages: loan application, borrower evaluation, loan analysis, approval and underwriting, and collection and monitoring (interviewed on 9 July 2009).

Figure 9.6. Loan Policy and Process



Source: Field research

Similar to the process of sourcing funding, most of lending activity is conducted through the OVC approach. In this practice, the marketing or loan officer comes to a prospective client's place of business to explain the BMT system and offers several loan schemes as well as funding products. At this stage, the officer registers the client as a member or, as sometimes happens, a candidate member (see Section 8.3) and collects personal data, records of past performance and other relevant information. The information is recorded on the loan application form including the amount of the loan requested by the client.

Client evaluation is the first critical stage of the loan process. Normally, this starts with administrative procedures such as personal identification, including home address and family background. This information should be accurate since it is used for further investigation like cross-checking regarding the client's reputation in the community, and their track record with other financial institutions, if any. In the next step, the BMT officer carries out a trustworthy and creditworthiness assessment as well as a business performance analysis. The most common technique that is used is similar to the 5 C's analysis of the general banking and microfinance approach. This analyses character, capacity, capital, condition and collateral.

In general, the practice of the 5 C's analysis in the BMTs is not as sophisticated as that employed by the Islamic banking counterparts. The majority of clients are classified as un-bankable and riskier borrowers because they lack adequate collateral to cover the loan. Thus, although the BMTs have developed their own loan analysis and risk mitigation methodology, the objective of the analysis is to prevent loan default.

The procedure carried out is as simple as possible and normally only focuses on the 3 C's aspects: character, capacity and capital. This simple assessment allows BMTs to simplify the loan processing system so as to generate a beneficial return for BMTs and reduce operational costs. Equally, the streamlined loan process provides easy and quick access to loans, thus enhancing client satisfaction and loyalty.

Character assessment is a very important aspect of microfinance. In this regard, the principal challenge for the loan officer is how to deal with the agency problem such as asymmetry information and dishonesty that could lead to credit default. As noted earlier, good character is understood to mean that the borrower is trustworthy, committed and responsible about the loan contract. Simply through conducting the client's character review and then by establishing an interpersonal relationship, the loan officer should able to subjectively judge the borrower's willingness and commitment to pay back the loan in the circumstance as detailed in the loan agreement, and to fulfil the terms and conditions of the BMT membership. In performing the client assessment, the loan officer usually uses a personal interview technique with open-ended questions and cross-checking in order to validate information given by the client, including to investigate the client's reputation.

In contrast to the LPD in Bali which employs the customary village system as a source of information and screening technique (Arsyad 2006), the BMTs mainly operate in an open communal society, where in the local market private matters are commonly shared among the traders, meaning the clients' character and reputation are well known in the community. In addition, the BMTs involve other key informants, such as the client's neighbours, relatives, business partners, local clerics and other informal community leaders, to assess the borrower's trustworthiness and social reputation. In short, through assessing the client's personal character attributes and reputation from different sources, the BMT is able to build up a sound and robust loan screening procedure.

The creditworthiness assessment framework is based on the capacity of borrower and existing tangible and intangible capital of the microenterprise. Better management and entrepreneurship capacity, along with greater capital available, would enhance the business's profitability and sustainability, which would make it viable and feasible to be financed by BMTs. During the personal interview, the loan officer also collects information regarding the client's capacity to manage the business. Normally, the officer identifies the borrower's capacity by analysing the development pattern of the business and several critical factors such as a profile of the founder and main decision maker, along with the age of the business. It is equally important to understand the family structure and number of family members involved in the business.

The BMTs' focus on financing existing businesses, with capital provided by the client, is a significant factor supporting the creditworthy of the BMTs' operations. The provision of capital by the client can take various forms including financial (tangible) capital, as stated in the balance sheet, and non-financial (intangible) capital such as established supplier networks, regular customers, and support from wealthy family members, informal leaders and eminent local clerics. The 3 Cs assessment framework, which focuses on the trustworthiness (high standards of commitment and responsibility) and the creditworthiness (capability and economic viability) of the borrower, enable BMTs to serve un-bankable segments of local communities that have not been serviced by the commercial banks.

After conducting the 3 C's analysis, the loan officer decides whether to proceed with or to reject the loan application. If it is feasible to finance the client's business, the officer calculates the loan amount and determines the type of loan – whether a partnership or mark-up financing scheme, the repayment plan (a daily or monthly repayment schedule) and if additional collateral is needed. Based on the loan application, the BMT manager conducts a final review of the loan's terms and conditions, and conducts an on-site visit before approving the loan. In a case where the value of the loan is above the authority limit of the BMT manager, the loan approval process is conducted by the credit committee, which involves the board of management. The loan underwriting procedure in BMTs is quite simple, as it comprises documentation of the loan contract, and witnessing by a public notary if the amount of the loan is considered significant. However, loan contracts below IDR 1 million are usually registered as non-legal binding agreements.

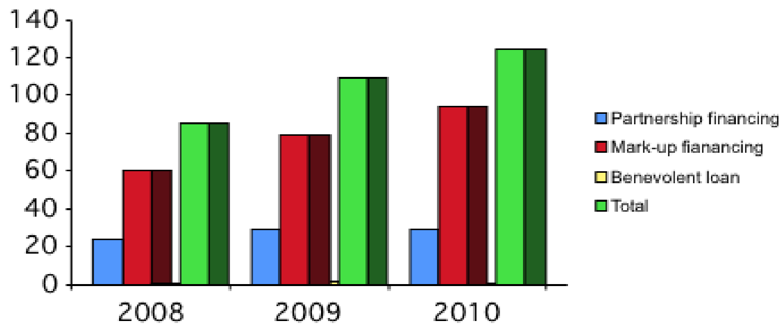
The final stage of the loan process is collection of repayments and monitoring, which is conducted using the OVC system and with daily on-site visits. In this regard, the loan officer simultaneously performs three different activities: he collects loan repayments, monitors credit performance and maintains a client relationship. From a risk management perspective, it is clear that the monitoring activities enable BMTs to achieve better loan performance and reduce loan defaults. More interestingly, if there is a loan default, the BMT officer commonly employs a persuasive approach by conducting intensive OVC and offering win–win problem solving strategies, such as repayment rescheduling rather than enforcing legal sanctions. In many cases, BMTs forgive loan defaults where they are due to unforeseen factors, reflecting the risk sharing mechanism of the Islamic microfinance system. The following section discusses the impact of loan defaults on the BMTs' sustainability.

9.3.2.2. Loan Performance

Of the 36 BMT samples, by the end of 2010 the total loan reached IDR 124.6 billion, which represented an increase of approximately IDR 39.8 billion or a 46.9 per cent increase compared to 2008. The figures indicate that the overall BMT sector has experienced steady loan growth and has sustained its intermediary financial function. The growth of the loan portfolio demonstrates the real demand for financial services, especially to meet the growing activities of microenterprises and the informal sector in the region.

As already mentioned, during the disaster recovery period the government and international donor organisations injected significant funds and donations to reconstruct the infrastructure and livelihood of people who were severely affected. The assistance was also allocated to recapitalise the BMT sector in order that it could continue or revive its financial intermediary function. In this context, the role of BMTs was critical in supporting local economic growth and assuming some of the role of the commercial banks that during the recovery period were more focused on internal consolidation and restructuring of non-performing loans. The flexibility of BMTs' operations and its unique position in the community meant that it could effectively reach out to the grassroots of the communities, especially to finance households that operate microbusinesses and other income-generating activities.

Figure 9.7. Loans Outstanding and Composition



Source: Calculation based on the financial reports of the BMTs surveyed

Figure 9.7 shows that mark-up financing is the dominant loan product – it accounted for nearly three quarters of the loan portfolio. These loans steadily increased in the three consecutive years 2008–10 with a net increase of IDR 34.2 billion (56.8 per cent). Mark-up financing and leasing schemes are arranged based on fixed instalments, on a daily, weekly or monthly basis, and proportionately calculated throughout the financing period, making these financing modes less complicated and in greater demand than the partnership contracts. However, because the mark-up financing procedures and practices are relatively similar to the conventional microcredit loans, according to Muhamad, a member of the DPS of several BMT institutions, the schemes have been criticised by Islamic scholars (interviewed on 15 July 2009).

During the same period, the partnership loan contract (PLS) was a less popular mode of financing. It represented only one-third of the total loan volume and had a growth rate of only half that of the mark-up financing loans, with a net increase of IDR 5.4 billion or 22.8 per cent. The partnership financing instruments are structured under the PLS system and adopt variable loan instalments (non-fixed interest repayments) based on a proportion of total revenue or net profit, calculated on a daily, weekly or monthly basis.

Arguably, the partnership schemes involve more complex features that can be confusing for new clients, particularly the changes in instalments over the period of the loan.

In addition, a small number of BMTs provide benevolent loans that are inherent to the *Baitul Maal* and charitable programs. These loans are not regarded by the BMTs as an important source of income. The financing procedures and repayment policies are very flexible and the beneficiaries are selected based on their welfare needs (see Chapter 8).

Within BMTs, there was wide variation in loan size; for instance in 2010 the average loan portfolio of BMTs in this research was roughly IDR 4.5 billion. According to asset volume, the cluster of larger BMTs provided the loans of highest value, on average IDR 18.9 billion. The cluster of middle-sized and smaller-sized BMTs recorded an average loan of IDR 7.6 billion and 2.6 billion. The corresponding figure shows that the lending capacity of the top BMTs is far greater than those BMTs in the smaller clusters. As previously mentioned, the top-tier BMTs are able to mobilise significantly larger funding and capital, have broader networks and have greater growth in their loan portfolios as well as being able to penetrate diverse microbusiness sectors.

Assessed by longevity, an identical pattern is apparent with long-established BMTs institutions having the bigger portfolios of outstanding loans. On average, the group of the oldest BMTs had portfolios of IDR 5.8 billion, whereas the younger cluster had loans averaging IDR 3.4 billion, while the youngest cluster had loan portfolios of IDR 2.3 billion. Analysed by region, the BMTs in Yogyakarta city recorded larger loan portfolios, on average IDR 9.6 billion. Interestingly, BMTs in Sleman and Bantul districts shared a nearly equal average loan size of IDR 3.6 billion, while the remaining BMTs in Kulon Progo and Gunung Kidul regions had loans outstanding of IDR 2.5 billion. In general, the adjoining regions of Yogyakarta, Sleman and Bantul were the most dynamic, providing ample business prospects for the BMTs.

Increasingly, many BMTs have diversified their target market in order to compensate for the effect of declining business volume in the traditional markets. According to Arif Yulian (Manager of BMT Bina Ummah), the strategy of diversification involves expanding the marketing activities away from traders in the traditional markets and targeting better-off potential borrowers like small enterprises and government contractors as well as providing consumer loans to civil servants and other fixed-salary employees. In addition, diversification spreads the risk of loan default and creates better economies of scale (interviewed on 10 June 2009).

9.3.2.3. Loan Quality

In theory, the viability of a BMT is determined not only by the capacity to increase the loan portfolio, but it is also influenced by the extent to which the institutions successfully manage the income-generating portfolio to produce strong performance.

According to the MENEGKOP-UKM regulation, loan quality is measured by the ratio of non-performing loans (NPL) to total outstanding loans expressed as a percentage.

The basic guide to measure loan quality is based on loan repayment (principal and associated return) on a specific schedule, for instance, daily, weekly or monthly, as determined in the loan contract. The non-interest loan system is more complicated compared to the conventional model because the nature of the loan contract is determined by the classification methodology. The methods of calculating a partnership loan, mark-up financing, leasing and debt involve different approaches. In practice, there is wide variation in how BMTs classified the loans; some BMTs follow the standardised model, and others modify the formula and simplify it. In effect, it is quite difficult to obtain an accurate portrait of the loan quality in aggregate. In this study, the data of loan quality was provided by BMTs, on the assumption that all the BMTs adopted the standardised loan classification. In the BMT sector, loans are classified into four categories:

- current,
- sub-standard,
- doubtful, and
- loss.

Moreover, loan categories 2, 3 and 4 are labelled as non-performing loans. Accordingly, based on the loan classification, the BMT institution should provide for loan losses (CPP) that are calculated as follow:

- 2.5. per cent of total current loans outstanding
- 25 per cent of sub-standard loans minus collateral

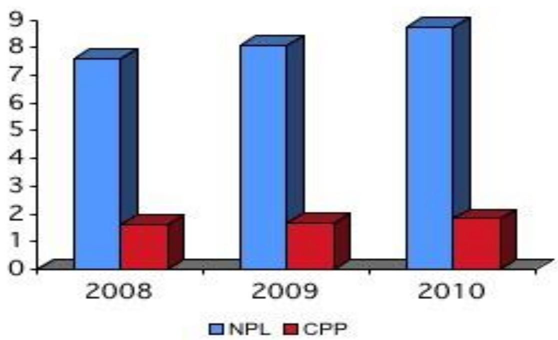
- 50 per cent of doubtful loans minus collateral
- 100 per cent of loss minus collateral.

While the collateral value is assessed on type and market price:

- 100 per cent for liquid collateral in the form of cash, savings and deposits in a BMT or commercial bank
- 100 per cent for the central bank certificate
- 70 per cent of market value for gold
- 70 per cent for property with a land certificate
- 50 per cent for property without land certificate

The fundamental criteria of the BMT loan classification and loan loss provision are adopted from commercial banking practice, characterised by a very robust and prudent design to anticipate financial losses due to loan default. The conceptual framework of loan loss provision means the greater the reserve, the better the BMTs are protected against losses. However, for small microfinance unprotected organisations with small loan portfolios, the methodology seems very complicated, time-consuming and difficult to implemented, especially in assessing the collateral value, since the majority of clients own unmarketable property. In this regard, the notion of loan collateral is emphasised more as a psychological and socio-religious obligation in order to eliminate dishonesty.

Figure 9.8. Loan Quality (NPL and CPP ratio)



Source: Calculation based on the financial reports of the BMTs surveyed

Figure 9.8 shows that the loan quality of BMTs followed a downward trend as the NPL ratio steadily increased from year to year. In 2008, the proportion of NPL of total loans was 7.63 per cent, then rose to 8.76 per cent in 2010. Similarly, the CPP ratio climbed from 1.64 per cent to 1.83 per cent. Arguably, there is no clear indication of to what extent the maximum level of NPL ratio should be maintained by BMTs, but the ideal NPL ratio should be as low as possible. As a benchmark, the central bank determines that the NPL ratio should not exceed 5.0 per cent, thus if this criterion is used it is clear when the loan quality is at an unsatisfactory level.

Interwoven factors influence the loan quality:

1. In theory, a significant loan expansion would drive loan quality down. Normally, an increase in the number of borrowers would affect the loan monitoring activities as the ratio of loan officers to borrowers increased. In microfinance, close personal relationships and an intensive monitoring system are essential to prevent loan defaults. Despite the BMTs using OVC methodology to collect loan instalments on a daily basis, fewer regular meetings increased the risk of poorer discipline and less psychological pressure on clients.
2. Typically, microbusinesses are cash-flow sensitive. During seasonal slowdowns in the business cycle, it is common for the clients to ask for short-term delays in payment of instalments, then they settle the outstanding amount when the business cycle returns to normal again. In addition, many reports reveal that the borrowers request delayed repayment due to emergency circumstances, like sickness and paying school fees.
3. Since the BMT system is influenced by Islamic values, its approach toward delinquent clients is generally persuasive in manner. In some cases, the persuasive strategy requires a longer time and more effort than other strategies like law enforcement.

Traditionally the main business of BMTs is to lend money to client members who are usually operators of microenterprises in the local communities, and so outstanding loans constitute the largest investment portfolio of the institution; this also plays very important role in generating income and sustaining the operation. In spite of BMTs using several loan schemes, the simple mark-up financing contract is the most popular because the clients find it easy to understand, with fixed instalments over the loan period. In general, the loan performance suggests stable growth, however there is the critical issue of loan quality, which has been gradually declining in the last few years.

9.3.3. Placement

In addition to providing loans, BMTs diversify their asset portfolio by placing some funds in commercial banks, both conventional and Islamic, and in other BMTs. Fund placement increased in consecutive financial years: IDR 6.2 billion (38.4 per cent) in 2009 and IDR 9.2 billion (40.9 per cent) in 2010. The main objective of employing an asset diversification strategy is to capitalise surplus funding into earning assets, and at the same time to maintain liquidity at an efficient level. Outstanding placements increased significantly because of liquidity management and an investment optimising strategy.

The common practice has been for BMTs to deposit their excess funds in commercial banks as a secondary reserve in order to anticipate saving and deposit withdrawals, in particular at the end of the financial year and during specific months when the clients need additional cash, such as during religious celebrations and at the beginning of the new academic year. Also, the reserve is an instrument to manage transitory funds that would be disbursed in the forthcoming loan cycle. In many cases, BMTs set loan disbursement schedules, e.g. on a weekly basis, thus the need for cash follows this schedule. The nature of this strategy is to allocate excess cash to earning investments, rather than leave the idle funds in safe deposit.[112] At the end of the financial year, the BMT institutions put substantial funds into placement accounts with attractive returns for short-term deposits with banks that need to meet their annual business targets.

Alongside the bank placements, BMTs also lend funds to other BMT counterparts both through direct inter-borrowing or via apex institution channels. The BMT inter-borrowing methodology is similar to the commercial money market, in which the surplus institutions put call money with deficit institutions. Usually the borrowing scheme is set in the form of short-term commercial loans in which the return is calculated based on PLS or the mark-up model. Consequently, the BMT lender would share the risk in any case of default. Although the inter-BMT placements generate

[112] For several reasons, some BMTs deposit excess funds in conventional banks, hence the interest income from the deposit should be accounted as non-permissible income and donated to a charity program.

higher returns than the bank placements, the majority of BMTs are very cautious because the risk of default of a BMT is relatively higher than that of BUS/UUS. According to the BMT managers, they are very strict in lending to other BMTs, favouring those who can provide valuable asset guarantees, because previous experience shows that inter-borrowing can lead to bad debts (FGD on 23 May 2010 in Yogyakarta). Thus, it is clear that bank placements are the more preferable treasury instrument than inter-borrowing with other BMTs; it is convenient and safer as the bank saving and deposit accounts are guaranteed by the state deposit insurance agency.

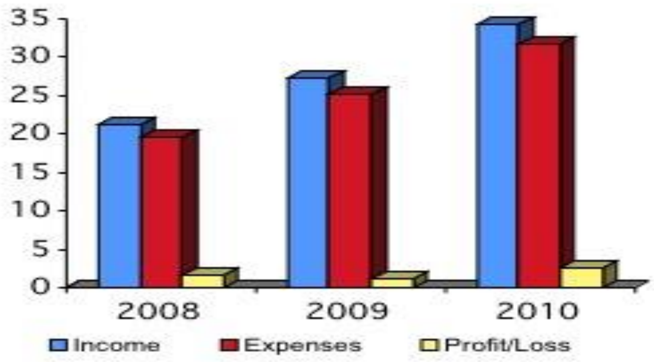
9.4. Profitability

Despite the fact that the BMT system embraces Islamic socio-religious values, sustainability is a prerequisite for BMT institutions to achieve their objectives to alleviate poverty through the provision of microfinance services. As stated by Robinson (2001), a sustainable microfinance institution not only serves poor borrowers but, more importantly, it does not burden the public budget. In other words, microfinance institutions should be self-sufficient and independent from government subsidies (Yaron 1992).

As discussed in Chapter 2, the main indicators of sustainability are profitability and financial self-sufficiency. In this study, the performance of BMTs is assessed through this framework, in particular by understanding the dynamic and interwoven factors that determine whether the BMT institution could sustain its operations and increase its service outreach in the Muslim community surrounding the Yogyakarta region (see further discussion in Chapter 4).

The BMTs examined recorded a net profit. In 2008 the profitability was IDR 1.8 billion and by the end of 2010 it had increased to IDR 2.6 billion – an increase of IDR 0.8 billion or 45.1 per cent. On average, each BMT recorded a net profit of IDR 95.5 million.

Figure 9.9. BMT Profitability

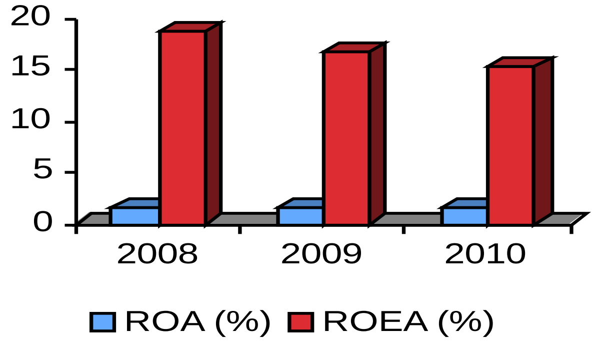


Source: Calculation based on the financial reports of the BMTs surveyed

During the consecutive financial years 2008–10, total income increased from IDR 21.3 billion to IDR 34.2 billion, a net growth of nearly IDR 12.9 billion or 60.4 per cent. Nearly all BMTs rely upon loan repayments to sustain their operations, although some BMTs also earn income from other activities like inter-BMT lending, deposit placements in the Islamic banks and transaction fees from electricity and telephone bill payment services. So when the income stream is broken down, it is evident that the instalment payments for loans accounted for over 80 per cent of the total revenue, and fee income contributed up to 9 per cent. In general, the operational income of BMTs constituted over 99 per cent of the total revenue.

Over the same period, total expenses were IDR 19.5 billion in 2008, which rose to IDR 31.6 billion in 2010 – an increase of IDR 12.1 billion or 61.9 per cent. In detail, the cost structure is dominated by the cost of funds, the total of the expenses that are related to fund mobilisation and borrowing, which accounted for nearly 40 per cent; management and staff salaries shared up to one third, and general administrative expenses were approximately a quarter of the total costs. The operational costs accounted for close to 98 per cent of total expenses.

Figure 9.10. Adjusted ROA and ROEA



Source: Calculation based on the financial reports of the BMTs surveyed

Further analysis reveals that, classified by the size of total assets-, the top-tier BMT group recorded profits on average of IDR 319 million, middle-sized BMTs earned an average profit of IDR 76 million, and the small-sized BMT cluster had an average net profit of IDR 36 million. The comparative figures suggest that the size of BMTs is the primary determinant of BMT performance. With a superior capacity to mobilise and employ the resources (funding and lending), the big BMTs could generate greater profitability compared with the middle-sized and small-sized BMT institutions as is reflected in the ratio between net profit and total assets (adjusted ROA): 1.7 per cent, 1.0 per cent and 1.3 per cent respectively. Similarly in terms of return on equity (adjusted ROE), the top five BMTs produced a return of 19.9 per cent, followed by the mid-sized BMTs' return of 12.5 per cent, and smaller BMTs return of 10.5 per cent.

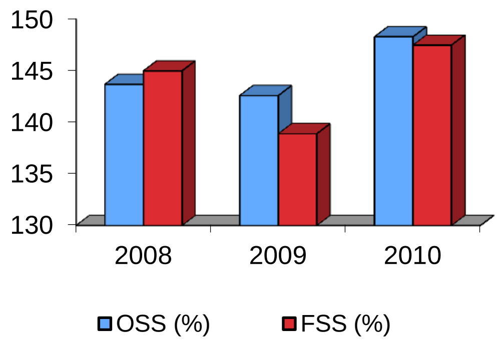
Analysing by the age of the establishment, the oldest BMT group had an average net profit of IDR 91 million while the other two BMT groups accounted for average profits of IDR 110 million and IDR 79 million. Furthermore, in terms of adjusted ROA, the respective clusters produced returns of 1.0 per cent, 2.2 per cent and 2.4 per cent, and adjusted ROE of 12.1 per cent, 18.5 per cent, and 24.5 per cent respectively. Interestingly, the findings demonstrate that the age of the establishment is less likely to be correlated with profitability because, as can be seen from the figures above, the younger BMTs performed better than the BMTs established for longer than 10 years. This evidence is consistent with the previous analysis that longevity of operations does not contribute to asset performance.

A further comparison, by region, reveals that BMTs in Yogyakarta city recorded the largest profitability, on average IDR 186 million, while those BMTs in Sleman district generated an average net profit of IDR 62 million, Bantul district BMTs recorded an average profit of IDR 133 million and other districts (Kulon Progo and Gunung Kidul) produced an average profit before tax of IDR 30 million. However, in respect of to what extent BMTs generated profit from asset utilisation, the figures reveal that BMTs in Bantul district produced the best performance of the adjusted ROA – 2.6 per cent, followed by BMTs in Yogyakarta city – 1.3 per cent, BMTs in Sleman district – 1.1, and the remaining districts of Kulon Progo and Gunung Kidul – 0.9 per cent. In respect of leverage, the adjusted ROE of BMTs in the two districts of Kulon Progo and Gunung Kidul produced the highest level – 19.1 per cent, followed by BMTs in Bantul district and Yogyakarta city that had nearly identical returns of 18.1 per cent, and the lowest were the BMTs in Sleman district with returns of 11.2 per cent.

9.5. Sustainability

In general, BMTs' sustainability can be measured by percentages of operational self-sufficiency (OSS) and financial self-sufficiency (FSS): 148.3 per cent and 147.5 per cent respectively. The OSS percentage indicates that the BMTs' revenue is able to cover the operating expenses. Alternatively, the percentage suggests BMTs generate adequate profit to sustain their operation. Furthermore, the FSS percentage reveals that BMTs are sustainable without external subsidies. This figure seems consistent with the previous evidence that BMTs relied upon public deposits and commercial borrowings to finance their loan portfolios. Also, from the profit and loss statements, it was evident that the operations of the BMTs were not subsidised by external grants to cover expenses.

Figure 9.11. Percentage of OSS and FSS



Source: Calculation based on the financial reports of the BMTs surveyed

From Figure 9.11., over the period 2008 to 2010, a positive trend in the BMTs' sustainability is shown, although there was fluctuation of the OSS and FSS ratio in 2009. The declining FSS is driven by a significant increase in the concession funds from LPDB, therefore in calculating the FSS ratio the effect of the subsidised cost of the fund is adjusted similar to the commercial fund.

Analysing by total assets, the small BMTs accounted for the highest OSS and FSS (185.1 per cent and 181.4 per cent, respectively), followed by the largest BMTs group (170.1 per cent and 170.6 per cent) and the cluster of middle-sized BMTs (133.0 per cent and 133.1 per cent). The possible explanation of these figures is that the small BMTs borrow less concession funds from the LPDB and/or receive subsidy grants from the local government. In contrast, the larger BMTs receive significant loans at below the market rate. The LPDB prefers to channel concession funds to the bigger BMTs as their capital structure is better than the smaller BMTs.

In terms of the year of establishment, the cluster of younger BMTs (below five years and between six and ten years) suggested better sustainability ratios compared to the oldest BMTs. It seems that the findings are similar to the previous phenomenon, in which the mature BMTs receive more funding assistance from government agencies. By location, BMTs in Kulon Progo district performed better than other regions, followed by BMTs in Bantul district, Yogyakarta city and Sleman district.

In general, the sustainability pathway of BMTs is determined by interconnected factors such as management capacity, provision of capital, funding resources and earning asset portfolio and loan quality. In Yogyakarta, the majority of BMTs strive to sustain growth, especially the small and middle-sized BMTs and those BMTs that operate in remote areas far away from the triangular economic zone. In contrast, the well-establish BMTs are in a relatively better position because of their own comparative advantages in terms of location, networks and institutional image. To sustain their operations, BMTs employ several approaches as follows:

1. Increase the economy of scale by maintaining steady growth, especially by expanding their loan provision and number of borrowers. The preferred strategy is to increase the operational outreach by expanding the branch network across the DIY region. The focus of business development is in traditional markets surrounding the Yogyakarta city and in the suburban area along the border with Sleman district. Extended office networks increase the potential for fund mobilisation and the provision of loans. In expanding the network, mostly BMTs use internal capital resources from organic growth, but several BMTs employ a franchise model (non-organic growth) by inviting local investors to establish a BMT outlet in their villages.
2. Establish linkages with other institutions including commercial banks (BUS, UUS, BPRS) and leading Islamic organisations. Linkages are very important to accelerate business growth, i.e. to obtain significant borrowing to increase loans outstanding. Establishing relationships with Islamic organisations would improve the BMTs image, and as a result the formal support from religious patrons would help BMTs to gain strong credibility from their followers. Thus, in consequence, it enables BMTs to increase their market share and outreach.
3. Small BMTs in remote villages and in the agriculture region, maintain their operations and growth by utilising the local resources, i.e. recruiting voluntary staff to minimise operational costs, and designing savings and loan products based on the seasonal agricultural pattern. To some extent, BMTs are inclined to strengthen their socio-religious mission and serve the poorer Muslim population.
4. Finally, there is direct association between BMTs' sustainability and *Sharia*-compliance. As mentioned in Chapter 8, the finding suggests that large numbers of BMTs do not conduct a *Sharia* compliance assessment. If any, it is only a general opinion without a detailed examination of financial transactions and contracts, the accounting system and other operational aspects. This fact reveals that the role of

the internal supervisory board (DP and DPS) and external monitoring from the MENEGKOP-UKM agency are more focused on financial compliance. Similarly, commercial banks (BUS/UUS) and other lending institutions, such as LPDB, PNM, INKPOSYAH and PUSKOPSYAH, also pay less attention to *Sharia* issues in granting loans to BMTs. Thus, BMTs pay more attention to financial performance and sustainability than to *Sharia* compliance.

9.6. Factors Affecting BMT Performance

As discussed in the previous chapters, performance and sustainability of BMTs is determined by several factors such as the involvement of influential founders and supporters, the capability of management and staff, and the local economic conditions where BMTs operate. However, the research suggests that there are also other influential factors that affect the performance of BMTs as presented in the following discussions.

9.6.1. Internal Fraud

Similar to the banking sector, as a microfinance institution, BMT deals with financial matters and agency problems that mean that BMT operations are not immune from typical irregularities, fraud and sophisticated financial crimes. There were several cases during the period of the study that showed three common types of fraud:

- Ponzy schemes involving fictitious saving and/or deposit accounts,
- fabricated loan disbursement, and
- misuse of cash.

The majority of perpetrators were BMT staff (tellers, loan officers) and managers, however some cases also involved external parties, i.e. client members.[113]

In general, the cases of fraud occurred because of lack of governance and supervision both from the internal supervisory board (DP and DPS) and the external body

[113] There are three BMTs that withdrew from the study because of fraud. One BMT refused to submit a financial report in the second year of observation without giving a reason, however, several informants told the researcher that BMT faced substantial NPL due to fabricated loan disbursement. In the case of the other two BMTs, there was misuse of funds by managers. Both BMTs were closed down by the local government and the managers were convicted of involvement in a Ponzy scheme.

(MENEGKOP-UKM). Despite the existence of a monitoring system in the BMT structure and standard operation procedures (SOP), the frequency of the cases of fraud demonstrate that managers and staff do not comply with the guidelines due to the negligence of the supervisory board in overseeing the daily operations of the BMT (on-site supervision), and reviewing and scrutinising the financial reporting system (off-site monitoring). According to Muhamad (interview on 15 July 2009), and confirmed by observations in the field, an ineffective internal supervisory function is reflected in the inadequate knowledge of DP and DPS members of the BMT system and the general practice of microfinance institutions.

It is important to note is that the majority of the members of DP and DSP are in voluntary positions and are not able to perform the monitoring task on a routine basis. Field observations indicated that some of the members have been chosen because of their status and credibility in the local community rather than their financial experience; others are investors in the BMT. In addition, Seibel (2008) indicates that in the absence of robust supervision and monitoring within the internal BMT organisation, in effect, the board of management does not have any early warning system or preventive mechanism to detect irregularities and fraudulent transactions.

Likewise, the field observations demonstrated that to some extent the external supervision from the MENEGKOP-UKM also failed to adequately oversee the BMT sector. First, the Ponzy cases often involved managers and staff of BMTs and other cooperatives (KSP). Second, there is no clear policy to prevent the cases of fraud through an improvement in the supervisory and monitoring systems. In many instances, MENEGKOP-UKM was slow to respond to the cases that have been exposed to the public. Previous research reveals that ineffective supervision is related to the lack of specialist cooperative superintendents, and a limited budget to conduct comprehensive monitoring and assessment of BMTs and the entire cooperative sector (Seibel 2008). See further discussion in Chapter 7.

In general, the cost of fraud has varied, but in terms of BMTs' total assets the loss substantially affects the performance of BMTs. According to the DIY Ombudsman (LOS), examples of such losses included BMT Amratani, which faced a loss of IDR 32 billion, BMT Isra lost IDR 51 billion and BMT Hilal lost IDR 22 billion (Ridareni 2011). These funds belonged to thousands of client members. The recent Ponzy cases have had a detrimental effect on the BMTs' performance; those BMTs involved were closed down by MENEGKOP-UKM.

In a broader perspective, the fraud schemes in the BMT sector have not only affected the performance and sustainability of the BMTs but have also created a domino effect, which has influenced the confidence and trust felt by client members about the practices of BMTs in managing their saving and deposit accounts. As BMTs are not part of the deposit insurance system, the fraud cases cause temporary withdrawal from saving and deposit accounts from BMTs. In addition, the fraud cases generate negative public criticism of the morals and honesty of BMT personnel, as the system is supposed to follow Islamic principles that strongly condemn deceptive and immoral conduct. It is not a generalisation, but the evidence of irregularities and fraud suggests that the process of internalisation and implementation of Islamic values into the BMT institutions still faces challenges.

9.6.2. Natural Disasters

On 25 October 2010, there was a volcanic eruption at Mount Merapi, close to Yogyakarta, within the study location of the BMTs in this research. Following the eruption, another field visit was conducted to the area from 25 May to 17 June 2011, to assess the impact of the disaster on the BMTs' performances. This further research showed how the natural disaster affected the performance of BMTs.

- 10 BMTs respondents in Sleman district were affected by the disaster because they were located close to Mt Merapi.
- BMTs within 20 km of the erupted volcano closed their operations for between one and two weeks.
- The majority of BMTs in the Sleman and Bantul districts, and Yogyakarta city, were affected due to the slowing down of economic activities, in particular those relating to agriculture, trade and tourism sectors.
- To minimise the impact, the government and aid agencies provided post-disaster relief in their recovery program**s,** to support BMTs and the clients.

There were two ways in which the BMTs were impacted by the disaster. First were those BMTs whose infrastructure and operations were directly affected by the eruption, as their income decreased and their expenditures increased to repair the damage.

Second, the disaster impacted on the BMT clients, so their loan performance reduced and the default rate increased. Funding was also affected as some clients withdrew funds from their saving and deposit accounts to rebuild their livelihoods. These BMTs experienced a decline in profitability.

Surprisingly, the Mt Merapi eruption did not affect the BMTs as severely as did the 2006 earthquake. The direct impact was that several BMTs in the disaster area temporarily closed their operations because the office buildings were damaged and their personnel injured. Of the BMTs directly affected, only one BMT was included in the study sample. According to Fitrie (Secretary of PUSKOPSYAH SLEMAN) the BMT reported losses in the months of November and December 2011, but overall this BMT reported an annual profit (interviewed on 15 April 2012).

In early 2012, the performance of the BMTs had recovered as they had received relief funds from the local government[114] and donors. The relief funds could be used for loans and eventually generated income. In addition to the indirect impact, the BMTs in the surrounding disaster area experienced temporary income interruption since some clients encountered business losses.

The BMTs played a significant role in the recovery program. The BMT sector, through the *Baitul Maal* function, was used to channel emergency relief funds, especially from individual donations and Islamic organisations. In addition, BMTs served to channel loans to the borrowers whenever the commercial banks reduced their activities in the disaster zone. This finding is similar to a study conducted by Loving and Sandusky (2010). They noted that, from field experience, microfinance institutions provided advantages during disaster relief and recovery period because they could maintain financial access to the community in the affected areas.

9.6. Summary

The chapter provided a comprehensive examination of BMTs' performance and sustainability. The overall findings demonstrate that the BMT sector in Yogyakarta is very dynamic and sustained its operations and service in the Muslim community, in

[114] The DIY provincial government and the Sleman administration granted IDR 1 billion to strengthen the funding of 10 BMTs after a disaster program.

particular the BMTs operating in traditional markets, business centres and dense residential areas in the city and suburban area of Yogyakarta. Only a small number of BMTs operate in rural and agriculture-based regions, where the local economy is seasonal and the money circulation relatively lower in terms of volume and turnover.

The BMTs in this study showed different attributes, features and standards of financial performance. The study finds there is no relationship between longevity and business development. However, the location of BMTs significantly influenced their business volume and profitability. The top-tier BMTs are mostly located in Yogyakarta city, Sleman and Bantul districts. The majority of BMTs sustain their operations by increasing their scale of economy and establishing relations with Islamic commercial banks and lenders, as well as with several leading Islamic organisations.

The performance and sustainability of BMTs is influenced by external factors as well; in this instance during the study period BMTs in Sleman district were faced with a natural disaster. However, fortunately, the impact of this catastrophe did not severely damage the BMTs' performance and the surrounding area. In effect, BMTs and the clients managed to recover in a very short period. BMTs played an important role in the relief program and post-disaster recovery. The BMTs' networks are able to substitute for the presence of commercial banks by providing financial services, especially loans to microenterprises and household income-generating activities. In addition, the *Baitul Maal* function could be used to channel emergency aid to reach the destitute, elderly and disable persons, orphans and the needy.

The next chapter draws together the findings of the study, its contribution to the existing theory, and recommendations for strengthening the BMT sector.

CHAPTER 10
CONCLUSION AND RECOMMENDATION

This thesis has examined the development of BMT institutions in the Yogyakarta region. It has addressed the research questions and the study objectives relating to the dual objectives of these faith-based community institutions, their sustainability and their effectiveness in alleviating poverty. The first section of the chapter summarises the findings. The second section identifies the theoretical implications of the study, and the final section discusses policy recommendations for the government and other stakeholders in the BMT sector.

10.1. Review of Findings

10.1.1. Establishment and Development of BMT Institutions

Considered in the national context, the BMT concept had its origins in the Islamic renaissance movement of the early 1990s. In particular, the creation of the BMT system was influenced by Muslim intellectuals in the Jakarta political elite, notably the National Islamic Council (MUI), the Muslim Intellectual Association (ICMI) and the Muhammadiyah leaders that shared a vision to establish a modern and prosperous Islamic society.

In the context of the BMT development in Yogyakarta, the role of the Jakarta elite was taken over by local community leaders, clerics, and young local activists. In this respect, the regional Muhammadiyah network played an important role in the implementation of BMTs and in the development of the movement to become the Islamic microfinance sector. In addition, the Dompet Dhuafa Foundation (DD) and PINBUK were the predominant supporters of the BMT movement through the provision of seed capital and technical assistance.

The research found that the BMT movement in Yogyakarta was not solely designed to alleviate chronic poverty in the region, but it was intentionally aimed to counter the hidden agenda of the Christian philanthropy program that flourished in the Muslim communities, especially in areas with a high incidence of poverty and in less-developed villages, for example in Gunung Kidul district. The BMT movement was seen as an alternative means of Islamic preaching (*Dakwah Muamalah*) in the communities, especially in developing the Islamic economic and financial system. In addition, the typical socioeconomic structure of the region, dominated by the informal sector, microenterprises, petty traders and cottage-based craftsmanship industries, was considered as a favourable ground for the BMT to provide faith-based microfinance services.

In general, the BMT sector cannot be isolated from the development of Islamic banking. In the initial phase, Islamic banking and microfinance were nearly stagnant due to a lack of government support, and limited knowledge and understanding of the majority Muslims about the faith-based banking and microfinance concept until 1997 when Indonesia was hit by the financial crisis. The crisis led to the political and economic reforms that provided plenty of opportunities for the Islamic approach to finance to develop, in particular after the dual banking system was introduced. In effect, the Islamic banking and microfinance systems grew together, along with their conventional counterparts.

The support of the Islamic society was growing as MUI published a formal jurisdiction prohibiting the payment of interest (*Riba*) under the Islamic tenet. Furthermore, in 2002 the Islamic Banking Law was introduced as a legitimate framework for Islamic banking and in 2004, the MENEGKOP-UKM was given the responsibility of regulating the BMT system as Islamic Cooperatives (KJKS).

With a legal structure as well as equal policy support from the government, the Islamic commercial banks (BUS and UUS) and the Islamic rural bank (BPRS) expanded significantly in terms of assets and the number of banks and networks. The Islamic banking sector developed with an annual growth rate above that of the conventional banking sector, and attracted many Muslims to use the non-interest banking products and services. However, the sector is relatively small as it only accounts for nearly 4 per cent of the total banking and finance industry (Juaro 2008).

The Islamic banking sector influenced the development of the BMTs. BMTs developed as an emerging Islamic microfinance sector across the island of Java, and in other provinces where Islamic traditions and Muslim traders have had a significant presence in local communities. However, due to the limited database in the MENEGKOP-UKM office and the lack of a standardised accounting and financial reporting system, it has been difficult to obtain an accurate picture of the BMT sector. However, Saat Suharto, the Director of PBMT, estimates the total number of BMTs to be between 3000 and 4000 units operating in Muslim communities, and serving over 1.5 million clients (interviewed on 4 May 2009).

10.1.2. Religious Dimension of BMT Institutions

The study found that the primary motivation underlying the BMT system is religious intermingled with socioeconomic objectives. The BMT conceptual framework follows the teachings of the Prophet Muhammad and His companions during the emerging Islamic civilisation era; that is, to alleviate the marginal livelihood of the destitute and poor Muslims and concurrently to enhance their religious devotion. In this respect, the core function of BMT is to collect and manage the almsgiving and religious donations for supporting the destitute and the needy as prescribed in the Qur'an.

Equally, it provides a faith-based microfinance service to the poor people and supports them to engage in productive economic activities and to become self-reliant. More explicitly, the founders and supporters of BMTs sought to eliminate the exploitative lending and unjust business practices of moneylenders and to provide alternative microfinance services in order to compete with the conventional microfinance institutions.

Within the framework of Islamic teachings, there are four elements of the BMT concept:

1. Spiritual values and images are translated into institutional attributes, signs and brands, and within the organisational structures, there are distinctive governance functions to oversee the religious mission, daily procedures and operations to ensure *Sharia* compliance.
2. Within the BMT institutions, spiritual teachings are internalised in the ethics and culture as well as in the conduct of management and in employee attitudes, behaviour and lifestyles in order to maintain the spirit of Islam (*Suasana Agamis*). In a concrete way, BMT personnel are encouraged to perform as an idealistic Muslim role model in the society.

3. The concept of the Islamic economic system and poverty alleviation programs are embedded in the modus operandi platform, the operational procedures and products, and in particular in the practices that proscribe the payment of interest, speculative and illicit behaviours and other unlawful business activities.
4. Finally, the research found that the socio-cultural environment of Yogyakarta was critical to the emergence of the BMTs. As the BMTs developed in the Muslim–Javanese cultural milieu of Yogyakarta, they established connections with local institutions and informal networks, in particular with the religious organisations and influential clerics.

10.1.3. BMT and its Dual Mission

The study showed that the majority of BMTs face a dilemma in performing the dual missions of socio-religious and economic objectives. First, in particular, the socio-religious (*Baitul Maal*) function to support the destitute and the needy is likely to be ineffective because of the lack of almsgiving and religious donations. As the BMTs operate in the lower socioeconomic segments of society, the capacity of almsgiving mobilisation is very limited and unable to fulfil the basic needs of this program on a regular basis. However, under the new *zakah* law (No. 23/2011) and the Government Edict No. 14/2014 provide a legitimate framework for a BMT to obtain formal license from the government (articles 57 and 58). In the future, the obstacle of BMT in rising philanthropy funds would be eliminated as *Baitul Maal* of BMT institution could access on the government almsgiving fund that is collected by BAZNAS.

Some BMTs seek philanthropic donations from outside the local communities where they operate, including from the almsgiving unit of the state-owned company (LAZIS) to maintain charitable program, but this strategy is not sustainable. Second, the BMTs that place more emphasis on their socio-religious program supporting the poor in income-generating activities tend to be perceived by the many local people as charity organisations rather than as microfinance institutions. Consequently, many potential borrowers are discouraged from taking out a loan, and so they forego the possibility of support for their micro-business. This means that combining the dual missions is difficult for BMTs to sustain.

The provision of benevolent loans can have a negative influence on the credibility and image of a BMT, with the result that BMTs tend to focus on internal almsgiving and distribute funds directly to the destitute and/or to support religious activities. The BMTs have been inclined to embrace the corporate social responsibility (CSR) approach instead of performing their dual missions.

The study confirms Aryo's research (Aryo 2009) that there are three variants of the BMT institutions in the region:

- profit motive (*Baitul Tamwil*),
- mixed profit and socio-religious motives (*Baitul Maal* and *Baitul Tamwil*),
- socio-religious motive (*Baitul Maal*).

This research found that the vast majority of BMTs are more dedicated to generating profits in order to maintain their long-term operations and financial sustainability. From the perspective of the *welfarist* microfinance approach (Woller et al. 1999; Yunus and Jolis 1998), the commercialisation of the BMT system from the pro-poor orientation to become a pro-market orientation is seen as an adjustment strategy in order to survive rather than as mission drift. It is evident that the BMTs remain focussed on reaching out the poor segments of the community.

10.1.4. Performance of BMT Institutions

As a community-based source of microfinance, the BMT institutions have performed their mission to reach out to the lower un-bankable segments and broadened their basic financial services to the communities that are not targeted by the mainstream formal financial institutions such as the conventional banks (i.e. the BRI microbanking units) and the Islamic commercial banks (e.g. BMI outlets) as well as the rural banks (BPR and BPRS). More specifically, the BMT institutions fill the niche by providing services for un-bankable clients, especially traders in the traditional markets. Thus, BMTs operate in an environment that is similar to that of the conventional microfinance counterparts, such as the cooperative microfinance (KSP) and other informal microfinance providers including moneylenders.

The study found that BMT institutions were flexible and adapted a mixed strategy of mingling local Javanese socio-culture and Islamic values quite successfully to attract ordinary Muslims. Also, the distinctive modus operandi allows BMTs to maintain their niche market and to sustain their operations in the face of intense competition from the other microfinance counterparts.

Research confirms that location significantly affects the performance of BMTs. In Yogyakarta, the economy is segmented into urban and suburban areas of Yogyakarta city, Sleman and Bantul districts. In the urban area of Yogyakarta, the microenterprises, petty traders and craftsmanship industries are highly diverse, especially those that are associated with tourism and the education sector. In effect, the high business turnover and cash flow supports a strong BMT sector. However, in the rural and agriculture regions economic activity is relatively limited and influenced by seasonal trade and commercial activities. The majority of BMTs are smaller in assets as well as in their capacity to expand their businesses.

The study identified the diverse nature of the BMT sector in the Yogyakarta region. The BMT sector is in a nascent stage of development and demonstrates high variation in the capacity, office networks, total assets, lending and funding capacity and overall profitability. The sector can be categorised into three groups based on their performance:

1. Top-tier BMTs manage substantial total assets; by the end of 2010 the average of total assets was IDR 18.9 billion, hence these institutions have larger funding and lending capabilities as well as a larger client base. Nearly all of these BMTs were among the first established in the triangle economic zone, primarily in Yogyakarta city. The institutions own several outlets in major traditional marketplaces and have continued to expand beyond the DIY region.
2. Second-tier BMTs operate in the suburb area of Sleman district. Several BMTs in this cluster have been in the community for over 10 years, but the total assets are less than half the size of the top-tier BMTs. In 2010, the average of their total assets was IDR 7.6 billion. Typically, these BMTs manage a single office in a traditional market.
3. Lower-tier BMTs are evenly distributed through the rural areas surrounding Yogyakarta. The majority of these BMTs are small in size and in 2010 had average total assets of IDR 2.6 billion. Unlike the BMTs in the other two groups, these BMTs are associated with the village and the agricultural economic sector.

On average, the BMTs managed total assets of roughly IDR 6.5 billion in 2010. The general trend suggests a steady growth of the BMTs with an average annual expansion of assets of over 21.3 per cent. This figure seems very sound, since it far exceeds the average inflation rate of 6.0 per cent.

The BMTs allocate their resources into highly productive investments, in order to maximise return. Thus, the BMTs earning assets account for nearly 85 per cent of the total assets. The well-established BMTs, in particular the top-tier BMTs, demonstrate better management and efficient asset allocation, therefore those generate healthier profitability compared to others.

The BMT institutions mobilise diverse funding sources, the most important of which are passbook saving and term deposit accounts. The member-based funding instrument is a vital source of funds for lending, as it accounts for nearly 70 per cent of the total funding. The top-tier BMTs mobilise funds more effectively compared to the other two groups, since the institutions manage more outlets and employ well-trained marketing officers. In 2010, the average amount of saving and deposit accounts was IDR 4.6 billion. BMTs employ the OVC strategy (*Jemput Bola*) by visiting the client sites in order to maintain close relationships and to hold this niche market of funding against competition from the commercial banks.

In addition, the BMTs involve the founders and the influential clerics to attract affluent clients, mosque and local Islamic organisations, as this strategy is an effective way to sustain the competitiveness of BMTs compared to the other community-based microfinance providers, for instance KSP. In addition, BMTs seek external borrowing from government agencies, Islamic banks and inter-borrowing from other BMTs to diversify their funding sources. On average, the volume of external borrowing was a quarter the size of the member-depositor-based funding.

The BMTs perform well in channelling their funds into loan portfolios, as is shown by the percentage of loans and deposits (LDR), which is above 100 per cent, although in 2010 the LDR slightly declined to 97 per cent. On average, the loan portfolio was IDR 4.5 billion. Similar to the funding capacity, the top-tier BMT institutions had a larger lending capacity compared to the other BMT groups. In addition, mark-up financing, i.e. the *Murabaha* contract, is the dominant loan product as it represents three-quarters of the loan portfolio. The mark-up loan is a popular product because of its simplicity and the fixed instalments, which makes it easy to manage; it is also familiar to the borrowers. However, as the *Murabaha* contract looks similar to conventional microcredit practice, it is perceived as not authentically representing Islamic microfinance and does not comply *Sharia* principles. The BMT lending activity is also conducted through the OVC approach, in which the loan officer regularly visits the borrowers to conduct loan selection, disbursement and collection of repayments. This mobile operation has enabled BMTs to broaden their networks into the un-bankable segments, like the petty traders in traditional marketplaces. BMT also employ simple loan procedures and flexible loan terms and conditions that are suitable for micro-businesses.

The distinctive modus operandi, internal procedures and policies, such as the intensive on-site visits, enable the BMTs to maintain the loan quality despite the fact that most clients are un-bankable entrepreneurs and low-income households that are regarded as risky borrowers by the commercial banks. In regard to the high non-performing loan aggregate (NPL), which in 2010 was 8.7 per cent, it seems that this figure was influenced by some BMTs that experienced cases of fraudulent loans. Another cause of the high NPL ratio was related to the loan administration methodology, where, due to the natural disaster in 2006, many BMTs had not written off default loans from the balance sheet.

The profitability of the BMTs was highly variable and in 2010 the average net profit was IDR 95.5 million, the adjusted return on asset ratio (ROA) was 1.45 per cent and the adjusted return on equity (ROE) was 1.72. The most important factors influencing profitability were operational income associated with net loan expansion, loan quality and rate of return, as well as operational expenses such as the costs of fund, personnel expenses, administrative expenditures and loan write-offs. Although profitability was relatively low, BMTs could maintain their sustainability, as the percentage of operational self-sufficiency (OSS) and financial self-sufficiency (FSS) were 148.3 per cent and 147.5 respectively. The percentage indicates that the BMTs could maintain their operations without external subsidies.

Comparatively, the BMT sector in Yogyakarta performed at a level below the performance of the LPD, a Hindu-Bali faith-based institution. In this regard, LPDs seems to have better profitability and financial viability (Arsyad 2006). The main reason why LPDs could maintain high performance is determined by the loan portfolio management, in particular if the repayment rate can be sustained above 97 per cent. LPD is part of the Balinese traditional village system that allows the involvement of the village administration and strict social sanctions when dealing with the NPL. This mechanism creates an intimidating effect on borrowers if they default on loans. In contrast, the BMTs are not part of the local administration and the approach of BMTs is mainly persuasive, in particular in the way they deal with default borrowers, instead of aggressive enforcement methods as practised in the LPDs.

10.1.5. Sustainable Pathway of BTM Institutions

The research evidence suggests that the BMT sector is progressing. The notion of sustainability drives BMTs to be more profitable and financially viable. Arguably, BMTs should maintain their growth at a particular level to sustain the operation by increasing the economies of scale. The main strategy to achieve this is by expanding the networks in the economic triangle zone around Yogyakarta.

There are three models that are used by the BMTs:

1. To establish branch offices, which allows the branch outlets to mobilise funds and disburse loans, but under the control of the head office. Typically, resource allocation is centralised in order to generate high returns.
2. The franchise or autonomy model invites Muslim investors to establish BMTs in their communities. Under the franchise model, BMTs establish a BMT network to facilitate inter-BMT members’ borrowing and loan syndication.
3. The final model is to develop strategic alliances with influential Islamic organisations, schools, universities and the Muslim business community. In the alliance strategy, the objective is for BMTs to broaden the sources of long-term funding

It is important to note that this research found that smaller asset size does not mean that BMTs are unsustainable. Several smaller BMTs in this research chose to limit the size of their assets so that they could focus on their socio-religious mission to support the needy and to serve the lower segment of the poor.

10.1.6. Impact of Fraud on BMT Performance

The cases of internal fraud have severely affected the performance of BMTs. In general there two direct impacts that drive BMTs into deficit and bankruptcy.

1. The BMTs lose huge amount of cash through fake loan disbursement, and saving or deposit mobilisation. In this instance, the BMTs replace the funds in order to maintain the trust and confidence of the members.
2. The fraud means that BMTs face a negative image and perception of the community; in effect it would affect saving and deposit performance, and the overall BMTs' profitability and sustainability.

10.1.7. Impact of Natural Disaster on BMT Performance

During the study, in late November 2011, there was volcanic disaster that hit the region, especially in the northern area of the Sleman district. This natural disaster impacted on the performance of the BMTs in two ways. First, the calamity directly hit the BMTs' infrastructure and disrupted their operation, as income and profitability decreased and expenditure increased to repair the damage. Second, there was a catastrophic impact on the BMTs' clients that influenced loan performance and led to an increase in loan defaults. In addition, clients withdrew their deposits to help them cope with the disaster.

As a direct impact of the disaster, several BMTs temporarily closed their operations because the office buildings were damaged and their personnel endangered. Of the BMTs directly affected, only one BMT reported a loss in the months of November and December 2011, following the disaster. Since the disaster occurred close to end of 2011, however, most of the BMTs produced a stable annual profit. In the next few months in early 2012, the performance of the BMTs recovered after they were granted relief funds from the local government and donors. These funds were used for loans that eventually generated income. The indirect impact of the disaster was that the BMTs in the area surrounding the disaster experienced a temporary loss of income since some clients experienced business losses.

Interestingly, the BMTs played a significant role in the recovery program. The BMT sector through the *Baitul Maal* function was used as a channel for emergency relief funds, especially from individual donations and Islamic organisations. In addition, BMTs were able to channel loans to borrowers, whereas the formal banks decreased their expansion in the disaster zone.

10.2. Study Implications

As previously discussed in Chapter 2, the underlying motive of the BMT system was to conduct the dual missions of the Islamic economic and financial system. The holistic dimensions of the BMT approach were to help alleviate poverty, and to empower people to be economically self-reliant through the abolition of *Riba* and the provision of accessible financial products and services.

This research found that the idealistic concept of the dual mission created a problem when the socio-religious programs were mixed with the commercial-based microfinance services. This research questions the claims that the BMT system would be an 'anti-thesis' of the *welfarist* and *institutionist* microfinance approaches as proposed by Aziz (2005). In the Islamic microfinance context, it is clear that the BMTs address 'the faith and profit' discourse by choosing to focus on one objective, whether it is the socio-religious impact or financial sustainability.

The BMT system has evolved in line with the development of the Islamic economic and financial sector. There are two notions in earlier studies associated with the BMT phenomenon. First, there is the argument that the transformation pathway in the Islamic financial BMT is a phenomenon of 'religious commodification' where Islamic values and symbols are employed as a marketing strategy to attract the Muslim community (Fealy 2008). Second, in the light of the social capital theory, the adoption and integration of Islamic symbolism and values into the BMTs is seen as a process of religious capital formation (Harrigan and El-Said 2009).

This study, from the broader perspective, suggests that the BMT system and the dynamic internalisation of the religious elements can be seen as a phenomenon of 'Islamisation of Muslims' and the 'refinement' of the traditional Islamic beliefs in order to cope with contemporary socio-cultural changes in society. The evidence suggests that the BMT case is more complex since the religious values and symbols are not only for creating an Islamic image, but are also internalised in the institutions' values, ethics, culture and lifestyle.

It is significant that this study produced similar findings to the LPD case study in Bali (Arsyad 2006). Arsyad's study suggests that the adoption of unique local traditions and religious values, and a Balinese village institution (*Banjar*) together with social norms and sanctions within a microfinance institutional structure and daily operation, would sustain the LPDs. The BMT case suggests that the Javanese socio-cultural milieu and the role of influential Islamic organisations and clerics have helped develop the BMTs as faith-based institutions with roots in the local communities they serve, and that are sustainable. This study confirms the previous proposition (Harper et al. 2008) that faith-based microfinance fits in the context where a religious mainstream is present in the community.

10.3. Policy Recommendations

The development of the BMT system as a means of Islamic community-based microfinance is relatively new and there remain plenty of opportunities for further study in many areas that have been highlighted in this study, including *Sharia* governance, legal factors, standards of supervision and financial intermediary as well as social intervention and the social and religious impact. In addition, this study was limited to an exploration of the BMT system as a unique microfinance institution. Future research could further investigate the socio-religious influence of the BMT programs in the internalisation process of Islamic values in the communities in which BMTs operate and how the *modus operandi* of the BMTs shape the religious consciousness of client members.

There is no doubt that the BMT sector has played important roles in poverty alleviation in the communities around Yogyakarta. The presence of the institutions allows poor people, especially unbanked segments, to access microfinance products and services. From the perspective of local sociocultural and religious practices, as well as economic setting, the case study of BMTs in Yogyakarta, especially the successful development of the sector, could be adopted by other provincial governments, Islamic organisations and other supporter of the BMT system in developing similar BMT programs. This study showed that socio-cultural context as well as structure of the economy in Yogyakarta supported the development of the BMT programs, but the supporting factors are not unique to Yogyakarta.

Considering the BMT function and the effective modus operandi as an Islamic community-based microfinance organisation, there are several issues that should be taken into account by supporters of the BMTs and the government in order to strengthen the future development of the BMT sector.

1. Strengthening *Sharia* governance. As a faith-based financial system, the fundamental BMT operation is ruled by *Fatwa* that are published by the National Islamic Council (DSN-MUI). In fact, the *Fatwa* are not specifically formulated for BMTs; instead the edicts are adopted from Islamic banking. Technically speaking, the BMT institutional arrangements and the nature of the products and services are quite different from the commercial Islamic banks, thus in many cases the *Fatwa* are not appropriate for the BMT system. The specific *Fatwa* issued for BMT are critically important in order to ensure that the authentic values and features of Islamic microfinance are implemented in the BMTs' daily operations and institutional structures. Equally important, the *Fatwa* should also address the *Sharia* governance framework, relating to the monitoring and supervision function, in particular to enhance the role of the *Sharia* supervisory board.

2. Following the recent enactment of the Microfinance Law (UU No. 1/2013), the BMT sector has been governed by the law. In the future, the BMT sector will be under the supervisory of the Financial Authority Body (OJK). In this context, the policy of integrating the BMT sector into the Islamic banking and finance sector could be easily implemented, and also the presence of OJK as supervisory body would improve the BMTs governance practices. In return, the BMT sector gains more support form the government as well as a more positive perception from the public. However There is a need for robust and comprehensive regulation and supervision that should address five central issues:
    - Faith-based cooperative microfinance models like the BMTs are different from the conventional cooperative microfinance model and the legal framework should accommodate their distinctive characteristics, instead of a 'one size fits all' regulatory and supervisory platform.
    - Protection of the membership and institutional interest is vital.
    - There is need for guidelines of prudential microfinance practices, risk mitigation and fraud prevention.

- The need for an improved internal and external supervisory mechanism; and
- Empowerment and law enforcement. In this context, the regulation and supervision of the BMT system should be integrated with the Microfinance Law, the Cooperative Law and the Almsgiving Law.

3. The provision of technical assistance and continued access to diverse sources of funding. From the outset, the BMT sector has been mainly supported by the Islamic civil society, however the support of government is essential to foster the development of faith-based microfinance programs. In this regard, the role of the MENEGKOP-UKM and local governments should be focused on improving the existing capacity-building programs, including the managerial training curriculum, professional development and certification of the board of management as well as improved training of management and staff. In addition, the government should broaden funding access, especially to assist BMTs to achieve optimal economies of scale. The BMT funding scheme should not be limited to the government and donor concessional loans but also should be open to more commercial lenders in the linkage program of BMTs and the Islamic banks.

4. As the BMT system is a unique approach to undertaking twofold functions: to sustain its operations through generating profits and also to serve the poor people, it seems that the government should provide a supportive policy, framework that enables access to funding through a *Sharia* commercial linkage program that allow BMTs to improve their capacity and, equally important, to have more access to almsgiving (BASNAS fund) in order to expand BMT operations to serve poor people and unbanked segment in communities.

5. The establishing of international benchmarks and cooperation. In recent years, the dynamic development of faith-based microfinance has become a matter of international interest, especially among Islamic nations. In this respect, there are two global agendas that should be considered:
   - As a variant of Islamic microfinance, the BMT model should be developed as a benchmark for other countries because, in many cases, BMTs have been

financially sustainable and their contribution to poverty alleviation has been significant.

- Indonesia, as the most populous Muslim country, should play an active role in the global Islamic microfinance movement through international cooperation with financial institutions, including the Islamic Development Bank (IDB) as well as undertaking research collaboration with leading universities to strengthen the Islamic microfinance model.

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LIST OF BMT INSTITUTIONS PARTICIPATING IN THE CLUSTER ANALYSIS

No.	BMT Institution	Registered Location
1	Agawe Makmur	Sleman
2	Al Ikhwan	Sleman
3	Al Muthiin	Bantul
4	Artha Amanah Sanden	Bantul
5	Arafah Mandiri	Kulon Progo
6	Assalam	Bantul
7	Bangun Rakyat Sejahtera	Yogyakarta City
8	Barokah Padi Mlati	Yogyakarta City
9	Beringharjo	Yogyakarta City
10	Bina Insanul Fikri	Yogyakarta City
11	Bina Martabat Insani	Yogyakarta City
12	Bina Ummah	Sleman
13	Bina Sejahtera	Kulon Progo
14	Budi Mulia Prambanan	Sleman
15	Dana Syariah Piyungan	Bantul
16	Graha Artha Muamalah	Kulon Progo
17	Insan Mandiri	Sleman
18	Mitrama	Bantul

19	Mitra Lohjinawi	Bantul
20	Mitra Usaha Insani	Sleman
21	Mitra Usaha Mulia	Sleman
22	Mitra Usaha Umat	Sleman
23	Mubarak	Gunung Kidul
24	Multazam	Bantul
25	Sejahtera	Sleman
26	Subusulsalam	Sleman
27	Surya Harapan Umat	Sleman
28	Surya Parama Artha	Kulon Progo