Allah and Micro-Finance?

Investigating Islamic Banking Principles in Indonesia's Microfinance Sector, and its Potential for Economic Empowerment

Name: Amina Samy

Despite the fact that the notion of 'development' has become more holistic in nature in recent decades, the importance of economic growth still remains pronounced, and it is difficult to find a definition of development that fails to incorporate this. However, our understanding of economic growth has shifted away from the simplistic notion of 'a total increase in GDP' (Todaro and Smith 2007, 15), and now includes ideas such as improved living standards and the freedom to succeed (Stiglitz 2003) as well as concepts of absolute (extreme) and relative poverty (Sachs 2005, 20).

Poverty is widely conceived to be the largest moral and economic challenge of this century, and thus it comes as no surprise that the first Millennium Development Goal attempts to tackle the issue of poverty eradication and "halve, between 1990 and 2015, the proportion of people whose income is less than a 1$ USD a day" (The United Nations 2009). One increasingly significant instrument of poverty alleviation and community development is that of microcredit and microsavings, popularized by Professor Muhammed Yunus and the Grameen Bank (Seibel 2008, 87). Microfinance is best defined as "the provision of financial services and products to those whose low economic standing excludes them from conventional financial institutions or programs" (Chowdhry 2008). Microfinance initiatives have been found to "increase household income and economic security, build assets and reduce vulnerability among the most impoverished in society" (Obaidullah 2008, 4), and as such they are potentially central to the challenge of ending poverty.

According to Mohammed Obaidullah, "Muslim societies fare far worse than the rest of the world in matters of addressing the problem of poverty" (Obaidullah 2008, 1); he claims that

in Indonesia alone, over half of the national population live on -or under- a mere US 2% daily (Obaidullah 2008, 1). The successful establishment of microfinance institutions in the Muslim world could prove to be a valuable asset in the fight against poverty. However, an additional obstacle is posed by Islamic *shariah*[1] which challenges conventional banking principles, mandating and promoting its own Islamic banking principles instead. As a result of this, "a few strands of Islamic microfinance, formal and semi-formal, have evolved" (Seibel 2008, 86) in recent years, combining Islamic banking principles to the principles of microfinance, in order to meet the growing needs of the Muslim poor.

According to Hans Dieter Seibel, who has conducted extensive research on both conventional and Islamic microfinancial services in Indonesia, Indonesia is "probably the country with the greatest diversity of both conventional and Islamic microfinance" (Seibel 2008, 89). Of central interest to this investigation are the *Baitul mal wal tamwil* i.e. the house of funds and finance (hereby referred to as BMTs which provide an "Islamic alternative for micro-enterprises in search of funds" (Antonio 2008, 256). The case of the BMTs has "proved that the application of Islamic values in microlending could be carried out profitably and in a sustainable form in Indonesia" (Antonio 2008, 256) resulting in the economic empowerment of Indonesia's urban and rural Muslim poor. Furthermore, the levels of social outreach demonstrated by these BMTs suggest societal growth and transformation in a way beneficial to the poor. However, it has also been indicated that the success of these BMTs is mixed and it has been implied that

[1] Shariah is an Arabic term, literally meaning 'way' or 'path' and refers to Islamic law and jurisprudence (Obaidullah 2008, 12)

weak institutions and poor governance have been a "key bottleneck, preventing their success" (Obaidullah 2008, 9).

In this paper, the main question that will addressed is whether the application of Islamic banking principles to microfinance in Indonesia has been more beneficial in promoting economic growth among the Muslim poor than conventional microfinance practices. And further, what this application can imply for the rest of the Muslim world.
To tackle this, a series of shorter questions will be answered. First, what distinguishes Islamic microfinance institutions from conventional microfinance institutions? Secondly, have the BMTs assisted in promoting economic growth and community development in Indonesia? If yes- how? And if not, why not? Thirdly, I intend to assess whether the mixed success of the BMTs is based on the religious principles underlying them.

In order to fully understand the implications of the application of Islamic banking principles to microfinance practices, it is useful to first appreciate Islamic views on poverty alleviation and familiarize ourselves with these principles.

As Obaidullah points out, "Islam views poverty as a curse to be eradicated, and it is the collective obligation of Muslim society to take care of the basic needs of the poor" (Obaidullah 2008, 13). Ideally, this is to be achieved in accordance with a system "based on cooperation, brotherhood and solidarity rather than on competition which leads to exploitation" (Seibel and Agung 2005, 56). It is believed that the conventional financial system fails to operate this way. The Islamic banking system can only be understood "in the context of Islamic attitudes towards ethics, wealth distribution, and social and economic justice" (Dhumale and Sapcanin 1999, 1). In

Islam, “concern for the less well-off” (Antonio 2008, 254) is strongly emphasized; so much so, that one of the five pillars of Islam (*zakat*[2]) is solely devoted to addressing this and assuring a more equitable distribution of wealth. Furthermore, the importance of justice is highlighted through “respect for property rights, protecting the sanctity of contracts and sharing both risk and reward” (Antonio 2008, 254).

The three basic principles of Islamic finance are: i) its interest-free nature, ii) the emphasis of profit sharing and mutual benefit, and iii) its dealings in only real economic transactions.

As is widely known, “Interest free transactions are a basic tenet of Islamic banking” (Dhumale and Sapcanin 1999, 2); however, Islamic finance is much broader than that. In Islam, “extracting a surplus value in an unfair way” (El Hawary and Grais 2005) is considered *haram*[3], which stems from “concerns over justice and fairness” (El Hawary and Grais 2005); as such, interest-based transactions are prohibited. Instead, transactions are based on profit sharing and mutual benefit. As Dhumale and Sapcanin argue, “profit-making addresses the Islamic ideals of social justice because both the entrepreneur and the lender bear the risk of the investment” (Dhumale and Sapcanin 1999, 2). Therefore, the Islamic bank or financial institution can be seen as an investor or shareholder, with direct interests in the successes or failures of entrepreneurial projects. Indeed because of this, Islamic banking encourages the formation of “mutually beneficial partnerships” (Seibel and Agung 2005, 56) in order for both the shareholder and entrepreneur to maximize their benefits. If profit-sharing mechanisms are

[2] A mandatory form of Islamic charity; it is the amount payable by a Muslim to charity as a proportion of his or her own wealth (Obaidullah 2008, 10, 62)
[3] In discord with shariah (Dhumale and Sapcanin 1999, 2)

not enough for a profit-seeking Islamic bank, they “may occasionally add an extra fee to compensate for costs incurred by the additional transactions they must undertake” (Dhumale and Sapcanin 1999, 5). This is not the case in Islamic microfinancial institutions. Finally, Islamic banking is conservative in character and “only real transactions with sufficient collateral, but no speculative investments, are financed” (Seibel 2008, 98)”; this is to say that any and all financial transactions need to be “directly or indirectly linked to a real economic transaction” (El Hawary and Grais 2005).

These principles are easily subscribed in both the larger Islamic commercial banks, and the more micro Islamic institutions. This is particularly true for two forms of Islamic banking- the *mudharaba*[4] and *musharaka*[5] models. The *mudharaba* model is one where “partners share profits” (Dhumale and Sapcanin 1999, 3). In this case, the bank provides the capital for the project while the entrepreneur provides the labour and expertise (Dhumale and Sapcanin 1999, 3, El Hawary and Grais 2005, Brugnoni n.d., 2). Whilst profits are shared, “financial losses are assumed entirely by the bank” (Dhumale and Sapcanin 1999, 3) and the entrepreneur will not be found liable “unless found guilty of negligence or mismanagement” (Dhumale and Sapcanin 1999, 4). The only loss to the entrepreneur is time and effort. Once a loan is repaid in full, a percentage of profit is no longer shared between the bank and the entrepreneur and the bank no longer occupies a “supervisory role in the project” (El Hawary and Grais 2005); in effect, the financier earns less profit with each payment received (Dhumale and Sapcanin 1999, 8). The *musharaka* model differs in that there is often more than one financier (Dhumale and Sapcanin

[4] Trustee Financing (El Hawary and Grais 2005)
[5] Equity Participation (El Hawary and Grais 2005)

1999, 4), and both profits and losses are divided amongst the shareholders (all financiers involved, as well as the entrepreneur). Profits and losses are “are shared according to the amounts of capital invested” (Dhumale and Sapcanin 1999, 4). Furthermore, the banks in the *musharaka* model take on a more participatory role relative to those in the *mudharaba* model (Dhumale and Sapcanin 1999, 4).

The merits of microfinance are well documented. However, it has been noted that the successes of conventional microfinance in the Islamic world are not as high as they could be, and it is implied that “financial exclusion is exacerbated in Muslim societies” (Obaidullah 2008, 12). Surveys suggest that the potential exists in the Islamic world to almost “double microfinance lending if ways can be found to address the constraints faced by households and firms that would qualify for loans and wish to borrow, but do not currently do so” (Arulpragasam and Alatas 2006, 27).

One of the main reasons for the apparent abhorrence of conventional microcredit is its “violation of the fundamental prohibition of *riba*[6] that the Islamic *shariah* mandates” (Obaidullah 2008, 2); because of this the more conservative of the Muslim poor opt to stay away. In addition, these rates of interest are often “found to be too high (sometimes as high as 80%) when benchmarked against mainstream banking rates” (Obaidullah 2008, 11); this makes it even harder for the poor to obtain credit. As Obaidullah also points out, “interest-based loans to the destitute may in fact make the poor poorer if they lack the opportunities to earn the cash flow necessary to repay the loans as well as the interest on them” (Obaidullah 2008, 10). Because of this it is argued that microfinance facilities can expand their outreach in the Islamic

[6] Prohibition of interest in Islamic shariah (Obaidullah 2008, 2)

world by offering Islamic banking services in communities reluctant to deal with conventional finance instruments, such as in Indonesia where it is estimated that “50% of households claim to lack access to the credit they need to fund their enterprises” (Sakai 2008, 268), despite the surge in microcredit schemes facilitated by the Indonesian government since 1980.

Islamic microfinance is most easily defined as “the collection of small savings and provision of small loans based on shariah” (Seibel 2008, 87) i.e. based on the Islamic banking principles detailed above. It is agreed that Islamic banking and microfinance programmes complement one another on ideological and practical terms (Dhumale and Sapcanin 1999, 1, Brugnoni n.d., 1, El Hawary and Grais 2005, Obaidullah 2008, 10). The concept of shared responsibility is especially relevant to the two principles. With this concept of joint liability, individuals come together to form small groups and collectively “apply and repay for the financing” (Obaidullah 2008, 6); in the case of cooperatives, they also pool together their resources, and manage the cooperative collectively.

Despite these parallels, initiatives in Islamic microfinance are “not widespread” (El Hawary and Grais 2005) and only a handful of successful units have been established. These include those of the Islami Bank Bangladesh, FINCA in Afghanistan and those in Jabal al-Hoss Syria (mandated by the UNDP) (El Hawary and Grais 2005).

For this paper, we will focus on the efforts of the member-based Islamic cooperatives in Indonesia called Baitul mal wal tamwil (BMT) that “provide charity based not-for-profit as well as for-profit financing” (Obaidullah 2008, 7) and serve as an example of a credit union which is non-profit in nature “owned and controlled by its members” (Obaidullah 2008, 7).

Before we begin analysis on the success or failure of BMTs in Indonesia, it will be useful to understand the basic history of Indonesia's economy in terms of the growth and development of Islamic banking and microfinance. Since the early 90s Islamic banking has evolved and has been popularized in Indonesia, mainly as a result of "political demands from Muslim scholars and organizations" (Seibel 2008, 90). In 1998 the Bank Indonesia (central bank) gave official recognition, as part of a new banking act, to the existence of a dual banking system: conventional and Islamic; figure 1 in appendix 2 illustrates the growth pattern of Islamic banking in Indonesia from its conception in the early 90s until 2006. The high growth rates shown are indicative of the growing popularity of Islamic banking in Indonesia. As figure 3 in appendix two illustrate, there are three types of Islamic banks: Islamic Commercial Banks (CBs), Islamic Rural Banks (BPRs) and Islamic Saving and Loan Cooperatives (BMTs). Of these, only CBs and BPRs are officially recognized and regulated by the government (Seibel and Agung 2005, 13). Islamic banking principles have also gained foothold in conventional commercial banks; due to increases in popularity, many non-Islamic commercial banks have diversified their services to include some *shariah* banking principles. As a result, the number of Islamic banking units within commercial banks has increased as well, though they are not recognized as Islamic banks.

With regards to microfinancial services, as previously mentioned, "Indonesia possesses one of the most differentiated microfinance institutions in the developing world" (Seibel 2008, 90), providing both conventional and Islamic microfinance. The majority of these microfinance institutions are located in urban and peri-urban areas (Seibel 2008, 90). Indonesia's microfinance sector caters to both livelihood and growth oriented enterprises. As Obaidullah

differentiates, "programs for developing livelihood enterprises have poverty reduction as their main objective" (Obaidullah 2008, 4). In contrast, "growth-oriented microenterprise programs have enterprise development as their immediate objective and attempt to lift microenterprises to a qualitatively higher level of sustainability" (Asian Development Bank 1997, 36). Microfinancial institutions that focus on livelihood enterprises thus target the impoverished, while microfinancial institutions that focus on growth oriented enterprises target small and medium enterprises; nevertheless both are essential to poverty alleviation in an area (Obaidullah 2008, 6).

First established in 1992, BMTs "compromise about 95% of Islamic cooperatives" (Seibel and Agung 2005, 13). A cooperative is best understood as "an autonomous association of persons united voluntarily to meet their common economic and social needs and aspirations through a jointly-owned and democratically-controlled enterprise" (International Co-operative Alliance 2007). The BMT model is an example of a credit union cooperative. Credit unions are best understood as "cooperative financial institutions that are owned and controlled by its members, and operate for the purpose of promoting thrift, providing credit at reasonable rates, and providing other financial services to its members" (World Council of Credit Unions 2009). Although credit unions operate on a macro and micro scale, BMTs operate on the micro-scale. This is demonstrated in figure 3 in appendix 2. As indicated, BMTs offer accessible micro-loans to their members. As well they require minimum capital from their clients and do not require business licenses or permits as a pre-requisite for loans. This implies that BMTs are able to provide financial access and services to the underserved and impoverished. The average size of a BMT cooperative ranges from 20-45 members (Obaidullah and Khan 2008, 27), and as

cooperatives “they are owned by their members” (Seibel and Agung 2005, 40). BMT’s claim “that profit sharing is more in the interest of the customers than interest-taking” (Seibel and Agung 2005, 50), and as such the loan portfolio of BMTs is shared between *murabaha*[7], *mudharaba* and *qard al-Hassan*[8], as illustrated by figure 4 in appendix 2.

Within Indonesia, BMTs are thought to “represent one of the most appropriate institutions for addressing entrenched poverty” (Antonio 2008, 258). As such, their growth and development has been advocated by national organizations such as the “Centre for Small Business Incubation (PINBUK) which was set up to act as an umbrella group for further BMT development in Indonesia” (Antonio 2008, 257, Utama 2006, 3) and the Muslim organization *Nadhatul Ulama* (Seibel and Agung 2005, 13). With this support, BMTs diversified from their Javanese origins to cities and regions across Indonesia, and today they represent over two thousand institutions serving millions of poor Indonesian Muslims” (Obaidullah and Khan 2008, 29) and “constitute 7.2% of all financial cooperative” (Seibel and Agung 2005, 32).

The BMTs have a mixed commercial and social orientation; in other words, they cater to the needs of both growth oriented and livelihood enterprises whilst also promoting positive social change (Sakai 2008, 276). The role of BMTs in enriching small and medium enterprises (SMEs) is particularly noted and relatively well documented.

For many decades, SMEs have played a significant role in the Indonesian economy (Antonio 2008, 252), enhancing economic growth and reducing unemployment. It is estimated

[7] “Where the provider of funds actually purchases the commodity and resells it to the user with a mark up against installments or delayed payment” (El Hawary and Grais 2005)
[8] “Beneficence loans: A loan extended without any interest or any other compensation. The lender expects only a reward from God” (Obaidullah 2008, 60, El Hawary and Grais 2005)

that SMEs contributed to "54.2% of Indonesian GDP in 2005 and absorbed about 79 million workers, equivalent to 96.8% of the Indonesian labour force" (Antonio 2008, 251). Despite their economic significance, "SMEs continue to have great difficulty gaining access to formal financial institutions" (Antonio 2008, 251).

Over the decades, SME development has been connected to contentious state policies. The *Benteng* programme of the 1970s intended to increase the number of SMEs in the import industry, but failed dismally "due to insufficient regulation by the government and the abuse of the licensing system by the participants" (Antonio 2008, 253). Under this programme, licenses were given to SMEs prioritizing them in the import business, and facilitating their growth. In most cases, these licenses were then sold to more well established, Chinese-controlled, companies" (Antonio 2008, 253) which "clearly defeated the purpose of enhancing the economic power of these entrepreneurs" (Antonio 2008, 253). Following this failure, the government switched its gears in support of the *asas pemerataan*- or even distribution- programme, which stated that "equality was to become a guiding principle in development policy, alongside high economic growth" (Antonio 2008, 253). This involved the creation of the Small Industry Centre (LIK) to fast-track the development of small industries as well as the introduction of the "foster-parent mechanism, which involved state-owned enterprises linking up with small-scale industries in subcontracting schemes" (Antonio 2008, 253). Additionally, it required "all state and private banks to allocate at least 20% of their loan portfolios to small business enterprises" (Antonio 2008, 253). This policy was not as successful as intended, as was the case with the *Benteng* programme.

These SMEs are ideal clients for the BMTs who claim that empowerment of the "lower risk and more crisis resilient" (Antonio 2008, 254) SMEs as one of their main objectives (Antonio 2008, 254, Seibel and Agung 2005, 40). In fact, BMTs are known to target small micro-entrepreneurs including 'itinerant travellers and food vendors" (Seibel and Agung 2005, 40). It is clear that Islamic microfinance institutions have the potential to accelerate the growth of SMEs and "provide an alternative source of financing" (Antonio 2008, 251) for them.

Aside from growth-oriented microfinance, BMTs are also able to offer livelihood enriching microfinancial services, and offer the working poor "a real chance at lifting themselves out of poverty" (Sakai 2008, 268), especially with their *qard al-Hassan* services and the BMTs tendency towards loan forgiveness (Seibel and Agung 2005, 57). Furthermore, BMTs offer several social outreach programmes such as "a scholarship scheme for orphans and health care assistance" (Sakai 2008, 277). It is also worth noting that the Islamic principles of brotherhood and community development that are behind these BMTs facilitate in the fostering of "strong personal ties that develop between members and managers, which further help building the community networks and trust that are essential to the success of a BMT" (Sakai 2008, 284).

Despite some noted successes, as detailed above, it is very difficult to accurately assess the performance of the BMTs in Indonesia, and even more difficult to assess their role in poverty alleviation. As several researchers in the area have noted, reliable data on Islamic cooperatives is missing (Seibel and Agung 2005, 50, Sakai 2008, 268, Obaidullah and Khan 2008, 29). As Seibel (who has done extensive research in the country) indicates "no information on

recent developments in an increasingly differentiated Islamic microfinance sector during the last three years is available" (Seibel 2008, 100); there is also a shortage of province specific information which makes cross-country comparison impossible. This stems from the fact that BMTs are informal institutions, not formally linked to the national monetary system, Bank Indonesia or the Ministry of Finance, and as such are not routinely regulated by them, or by anyone (Antonio 2008, 258). Since registration with the Ministry of Cooperatives is optional and not compulsory, it is estimated that roughly, only 16% of BMTs are registered with the Ministry of Cooperatives, and "only those 16% are required to send annual reports" (Seibel and Agung 2005, 40). To add to that, the Ministry of Cooperatives "with its unclear and perhaps counterproductive functions" (Seibel and Agung 2005, 35) does not even perform its functions adequately (Seibel and Agung 2005, 35), and there is "no performance measure used to assess the institutional quality of each BMT" (Seibel and Agung 2005, 41). Without these, the BMT framework cannot be expected to improve itself. In fact, it can be said that "unsupervised Islamic- like conventional- cooperatives are an outright menace to their own members, who risk losing their savings" (Seibel 2008, 86, 100). In an increasingly decentralized Indonesia, "cooperatives are now being registered autonomously, which is likely to make the task of regulation and supervision even more difficult in the future" (Seibel and Agung 2005, 35).

It is also worth noting that Islamic microfinance institutions are few in number and roughly only 4% of micro and rural finance initiatives in Indonesia are Islamic in nature (Seibel 2008, 90). Conventional institutions outnumber, by far, Islamic ones both in terms of absolute number and growth rates.

From what little that can be determined, it is evident that BMTs have not been performing as well as expected. As Seibel notes, there is an "overall poor performance" (Seibel 2008, 96) and the large majority of BMTs are dormant- or worse- technically bankrupt (Seibel 2008, 96). This poor performance can be linked to poor management practices (Seibel 2008, 94) (Seibel and Agung 2005, 41) and the lack of adequate Islamic banking experience (Seibel 2008, 95). In most cases, BMT members lack training and experience in "banking, financial analysis, marketing as well as personal and team building" (Utama 2006, 9). Furthermore, as indicated above, BMTs have a tendency towards debt forgiveness and leniency (Seibel and Agung 2005, 57) and overemphasize their focus on the "informal sector" rather than on the more "profitable" sectors (Seibel 2008, 95)- all this indicating poor management practices. Furthermore, it has been suggested that "only the larger commercial banks have successfully acquired the complex art of Islamic banking" (Seibel 2008, 86), however, they "lack experience in microfinance as a specialized field" (Seibel 2008, 100).

Recall our second question: *have the BMTs assisted in promoting economic growth and community development in Indonesia? If yes- how? And if not, why not?* Because of the lack of adequate information, we cannot accurately and quantitatively deduce if the BMTs have assisted in poverty alleviation in Indonesia. In practice, as shown in the literature, BMTs could prove instrumental in economic empowerment and enterprise development in Indonesia. However, in theory, it is indicated that managerial and bureaucratic bottlenecks have prevented BMTs from reaching their full potential, and unless these issues are resolved effectively, the success of the BMT model is limited.

This, however, does not imply that religious factors have not played a role in the reported mixed success of the BMTs. As Seibel and Agung point out "there is no real indication that the establishment of Islamic banks in Indonesia was preceded by broad popular demand for Islamic financial services" (Seibel and Agung 2005, 17), as previously assumed. According to their study, in surveys carried out in several provinces with an average Muslim population of 97%, only 11% were found to understand the products or benefits of *shariah* banking (Seibel and Agung 2005, 17). Seibel's later study confirms that there is a "lack of popular demand for Islamic banking services" (Seibel 2008, 95). It is also indicated that "borrowers did not like the profit-sharing of the *mudharaba* model [which accounts for roughly 30% of all BMT loans] because they did not want to reveal their profits to the programme (or the rest of their group)" (Dhumale and Sapcanin 1999, 12). Despite this revelation, religious concerns- or rather lack of popular demand for religious services- is not a significant enough factor in accounting for the mixed success of BMTs. As qualitative research shows, a more religion-neutral perspective is taken by the majority of the BMTs clientele, who site flexibility, accessibility and affordable rates as the main reasons behind their choice of institution (Sakai 2008); the utility of Islamic banking principles did not affect the decisions of most customers (Sakai 2008) with the noted exception of the *pesantren*[9] students. As Seibel and Agung pointed out, "people prefer a bank system for its better service in general, facilities provided, credibility and bank status; people tend to avoid *shariah* banks for their limited services and facilities, poor services, and low credibility and not because of its *shariah* nature" (Seibel and Agung 2005, 32) Therefore, it can be concluded that the lack of practical success of the BMTs in Indonesia is more due to poor

[9] Islamic boarding schools in Indonesia

managerial practices and bureaucratic bottlenecks rather than on the Islamic principles that are underlying the model.

“Despite the institutional problems of the cooperative sector in Indonesia, the BMT model remains one of the most robust and least-cost models of decentralized financial intermediation” (Utama 2006, 5); In order for these BMTs to be more practical in the economic empowerment of Indonesia’s poor, the bottlenecks described above need to be sufficiently addressed. The most effective way to achieve this is through financial and institutional strengthening, by means of “increased coordination between Islamic commercial banks, various government agencies and NGOs and other Islamic financial institutions” (Antonio 2008, 258). The BMTs should also look to align themselves more closely with the conventional, and reportedly more successful, microfinance sector. As Seibel contends, “the expertise and knowledge of commercial banks in setting up branch networks of Islamic micro-finance institutions should be utilized” (Seibel 2008, 101); particularly the expertise of the conventional Bank Rakyat Indonesia (BRI) who implemented “one of the most successful microfinance models worldwide” (Seibel 2008, 90). Close alliances with the formal, dual, financial sector can also provide BMTs “access to fresh funds, thereby strengthening its liquidity” (Antonio 2008, 261). Furthermore, legal action can be taken to formalize BMTs, thereby ensuring their registration with the Ministry of Cooperatives, as well as their regulation and supervision. As Obaidullah contends, “micro-finance works best when it measures-and discloses- its performance. Reporting not only helps stakeholders judge costs and benefits, but it also improves performance” (Obaidullah 2008, 9).

Another plausible suggestion for improving the potential of the BMT model is to align it more closely with successful foreign NGOs and institutions. As in the case of the BMTs (aka *Baitul Qurads* or BQs) in the Aceh province, which were provided with technical assistance from the German Technical Assistance (GTZ) as highlighted by Seibel and Utama (Seibel 2008, Utama 2006). In their joint-programme the GTZ realized the failures of the existing BMT model and as such, revamped it to create the BQ model. Their approach is highlighted in figure 5 in appendix 2. The study and mapping conducted by the GTZ shows that the cooperative system in the province is still "underdeveloped" (Utama 2006, 6), but that there is significant room for improvement. As figure 5 demonstrates, the model takes place on four levels: micro, meso, macro and meta. At the micro level, new BQs are established and the members of the BQ would collectively raise a select amount of capital and obtain legal status as a "savings and credit cooperative" (Utama 2006, 9) in order to be eligible for technical assistance; this intended to ensure autonomy as well as regulation and supervision. The technical assistance provided by the GTZ at this stage would include "education and training for the members, particularly in cooperative principles, Islamic finance, banking, financing analysis, marketing as well as personal and team building" (Utama 2006, 9). A more elaborate map of this micro stage is illustrated in figure 6 in appendix 2. At the meso stage, the initial BQs will create secondary BQs (Utama 2006, 11), as well as establish a BQ centre "to provide necessary services and become the development centre, providing training for members" (Utama 2006, 11). At this stage, cooperation and networking between BQs is strengthened (Utama 2006, 11). At the macro and meta levels, "cooperative offices monitor and supervise the performance of financial cooperatives and are involved in every activity" (Utama 2006, 12). This more holistic approach

is believed to result in the regaining of society's trust in the Islamic cooperative sector" (Utama 2006, 12). However, it is interesting to note that this proposed model is more top-down in nature than the bottom-up previous BMT model, and this may have further implications in the long-run future of Islamic microfinancial institutions in Indonesia.

With surges in population growth in the impoverished Islamic world, and growing income disparities in the increasingly globalized world, the potential for Islamic microfinance for the economic empowerment of the Muslim poor is enormous. As Dhumale and Sapcanin conclude, "Islamic banking techniques could give thousands of the entrepreneurial poor access to microfinance- an option they might not consider if traditional, interest based commercial loans were offered" (Dhumale and Sapcanin 1999, 13). However, as made evident by our investigation of the microfinancial, Islamic Savings and Loan Cooperatives or BMTs what looks good on paper, does not always materialize so positively in reality. In order for Islamic microfinance to be efficient and beneficial for the Muslim poor in Indonesia (and indeed the rest of the Muslim world), it "must develop links with the formal Islamic banking sector and capital markets" (Brugnoni n.d., 23) and build the appropriate institutional capabilities required. As noted previously, there is a "lack of efficient institutional structures supporting micro *shariah* banking operations and managers and focus should be redirected into supporting building capacities" (Seibel and Agung 2005, 14) and these key bottlenecks need to be ameliorated if effective societal transformation is desired.

The case of the BMTs in Indonesia demonstrates that the inclusion of religious actors in development policy may not necessarily provide the answer to existing problems. In this case

religious actors and institutions were actively involved in the development process, and yet despite this the policies implemented did not succeed as expected. This, as shown, has nothing to do with religious involvement, but rather the fact that the capacity for their efficient engagement was not built and the institutions needed for their success were not set in place. The case of the BMTs in Indonesia clearly highlights the importance of strong institutions and good governance in economic empowerment and poverty alleviation, and once again emphasizes that the development process is multi-faceted. With these established, there is no reason why Islamic microfinance cannot be successful in Indonesia or in the rest of the world.

Appendix 1: Glossary of Islamic Finance and Banking Terms

Term	Definition
Bai-Bithaman-Ajil	"Sale of credit i.e. a sale in which goods are delivered immediately but payment is deferred" (Obaidullah 2008, 59)
Bai-Mua'jjal	"Deferred payments or spot sales in which the seller of the product accepts deferred payments in instalments or in a lump sum. The price is agreed upon by the buyer and the seller prior to the sale, and the seller is not allowed to include any charge for deferring payments" (Dhumale and Sapcanin 1999, 5)
Bai-Salam	"A sale in which payment is made in advance by the buyer and the delivery of the goods is deferred by the seller" (Obaidullah 2008, 59)
Ijara	"Leasing. Sale of usufruct of an asset. The lessor (provider of the funds) retains the ownership of the asset will all the rights and the responsibilities that go with it" (Obaidullah 2008, 59)
Mudharabah	"Trustee Financing: The owner of funds finances the entire project while the entrepreneur offers her labor, time and expertise. Profits are shared between them at a certain pre-determined ratio, whereas any financial losses are exclusively borne by the financier" (El Hawary and Grais 2005)
Murabaha	"Where the provider of funds actually purchases the commodity and resells it to the user with a mark up against installments or delayed payment" (El Hawary and Grais 2005)
Musharaka	"Equity Participation" The financier enters into an equity participation agreement with other partners to jointly finance an investment project and participate in its management. Profits (and losses) are shared among partners based on their respective contributions to capital" (El Hawary and Grais 2005)
Qard Hasan	"Beneficence loans: A loan extended without any interest or any other compensation. The

	lender expects only a reward from God" (Obaidullah 2008, 60, El Hawary and Grais 2005)
Riba	Interest. "Refers to the premium that must be paid by the borrower to the lender, along with the principal amount, as a condition for the loan" (Obaidullah 2008, 60)
Takaful-Tawuni	An alternative to insurance, where a group of persons agree to share certain risk by collecting a specified sum from each. In case of a loss, funds are derived from this pool (Obaidullah 2008, 61)
Wadiah	"A contract whereby a person leaves valuables with someone for safekeeping. This service is encouraged in Islam to be free of charge" (Obaidullah 2008, 61)
Wakalah	"where the bank acts as an agent or an intermediary and is paid a fee for its services" (Antonio 2008, 259)
Zakat	A mandatory form of Islamic charity; it is the amount payable by a Muslim to charity as a proportion of his or her own wealth (Obaidullah 2008, 10, 62)

Appendix 2: Tables and Charts

Figure 1: Growth of Islamic Banking in Indonesia from 1991-2006, (Seibel 2008, 91)

Type of Islamic Bank	1991	1992	1999	2000	2001	2002	2003	2004	2005	2006
Commercial Banks (CB)	0	1	2	2	2	2	2	3	3	3
CB Units	0	0	1	3	3	6	8	15	19	22
Total CB Offices	0	1	40	62	96	127	299	401	504	636
Rural Banks (BPR)	4	9	78	78	81	83	84	86	92	105
Total Number of Banks	4	10	81	83	86	91	94	104	114	130
% Growth	-	150%	710%	2.5%	3.6%	5.8%	3.3%	10.6%	9.6%	14%
Total Number of Offices	4	10	118	140	177	210	383	487	596	741
% Growth	-	150%	1080%	18.6%	26.4%	18.6%	82.4%	27.1%	22.4%	24.3%

Figure 2: Categorization of Small and Micro-financial Institutions in Indonesia (Antonio 2008, 255)

Formal		Informal
Bank	**Non Bank Financial Institutions**	
Commercial Banks (Bank Umum)	Village Funding and Finance Institutions (LDKPs)	Self-Help Groups (KSMs)*
Rural Banks (Bank Perkreditan Rakyat- BPRs)	Cooperatives	NGOs
		Islamic Saving and Loan Cooperatives (BMTs)

* A Self-Help Group is understood as a "ten-fifteen members group who are relatively homogenous in terms of income; essentially, this group pools together their members savings and uses it for lending purposes" (Obaidullah 2008, 8)

Figure 3: Islamic Banks and Finance Companies by Size of Capital and Credit Limit (Antonio 2008, 255)

Type of Islamic Bank	Categorization	Regulation	Minimum Capital (i.e. minimum amount required for eligibility) (Rupiyah)	Credit per Customer (i.e. provision of loans, per customer) (Rupiyah)
Islamic Commercial Bank	Formal, Bank	Bank of Indonesia	1 trillion	100 million +
Islamic Rural Bank (BPRS)	Formal, Bank	Bank of Indonesia	500 million-2billion	5-100 million
Islamic Saving and Loan Cooperatives (BMTs)	Informal	'Foster' institutions e.g. the Institutes for the Development of KSMs i.e. PINBUK, and the Ministry of Cooperatives (MOC)	10-100 million*	100,000-10 million

Note: For ease of conversion, 10,000,000 Rupiyah=1,100 CAD roughly

* Furthermore, they do not require customers to hold business licenses or permits- documents that few of the impoverished would hold- as a prerequisite for funding (Antonio 2008, 258)

Figure 4: Loan Portfolio of BMTs (Seibel and Agung 2005)

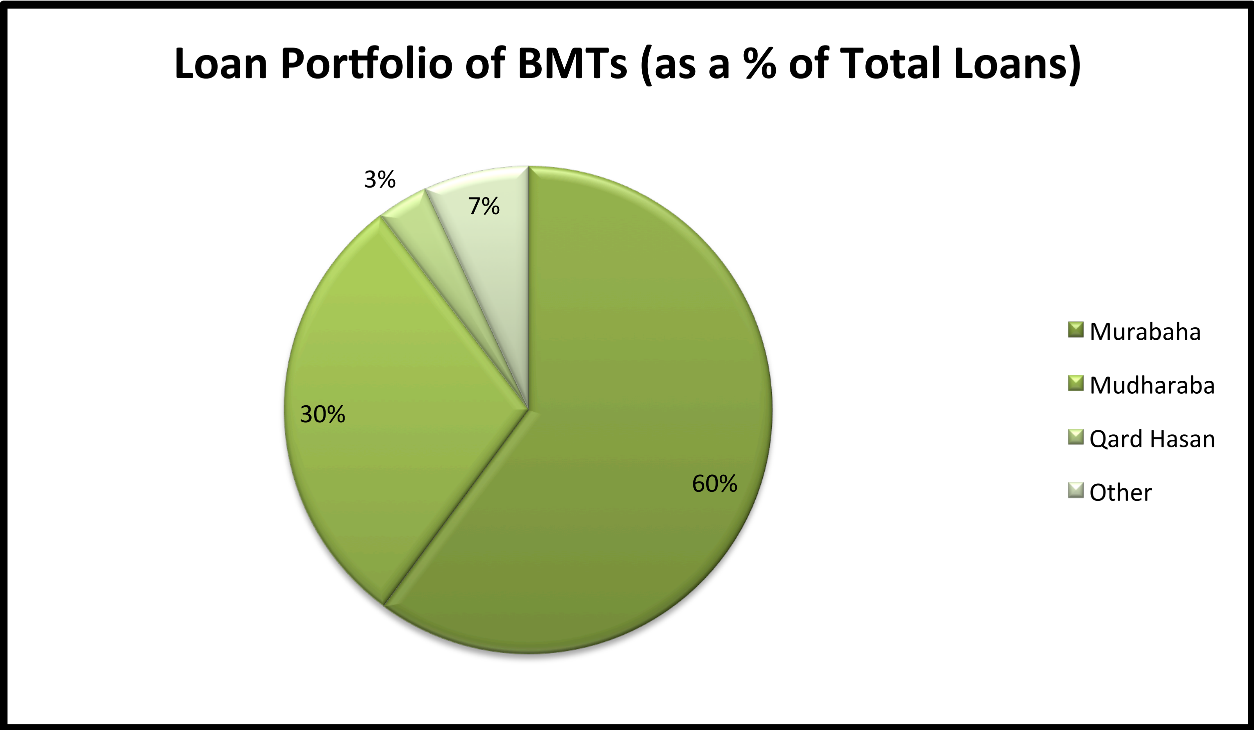


Figure 5: Baitul Qurad Development Approach (Utama 2006, 8)

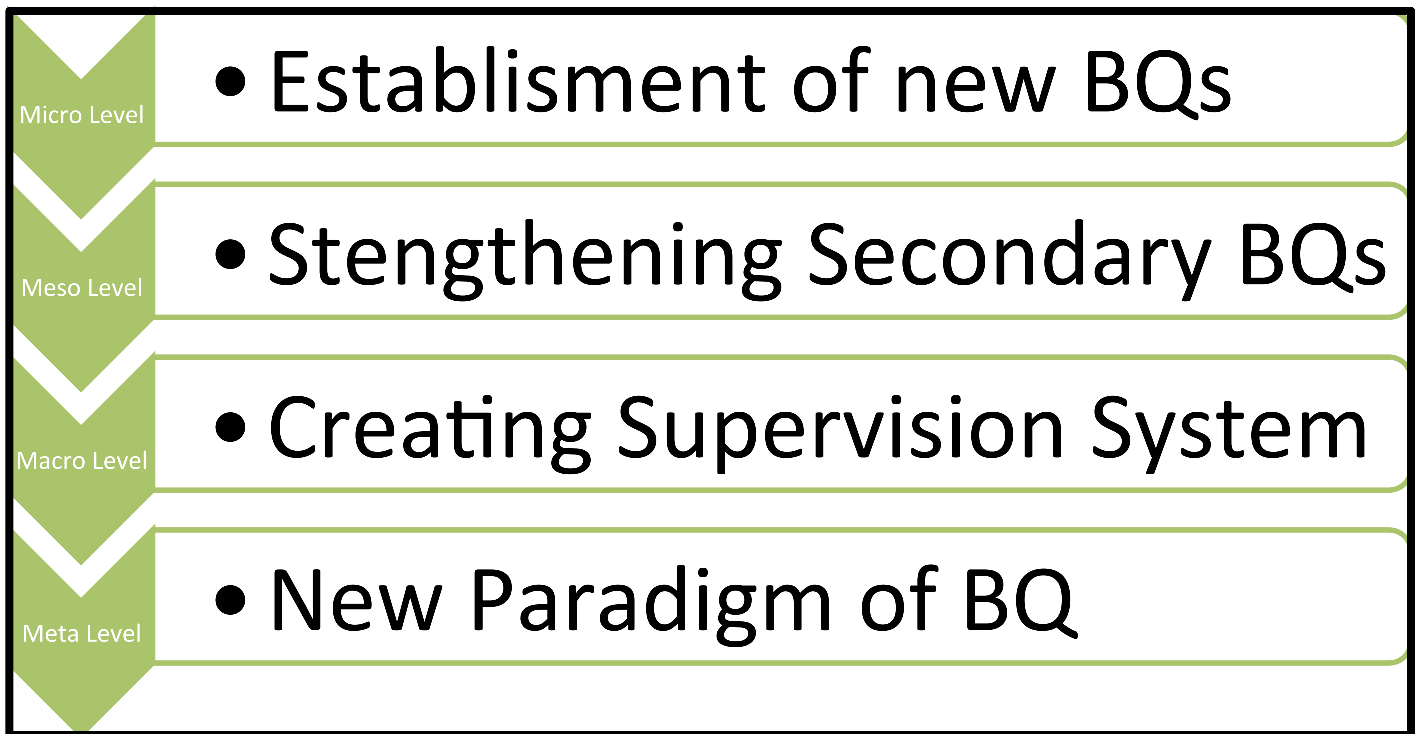
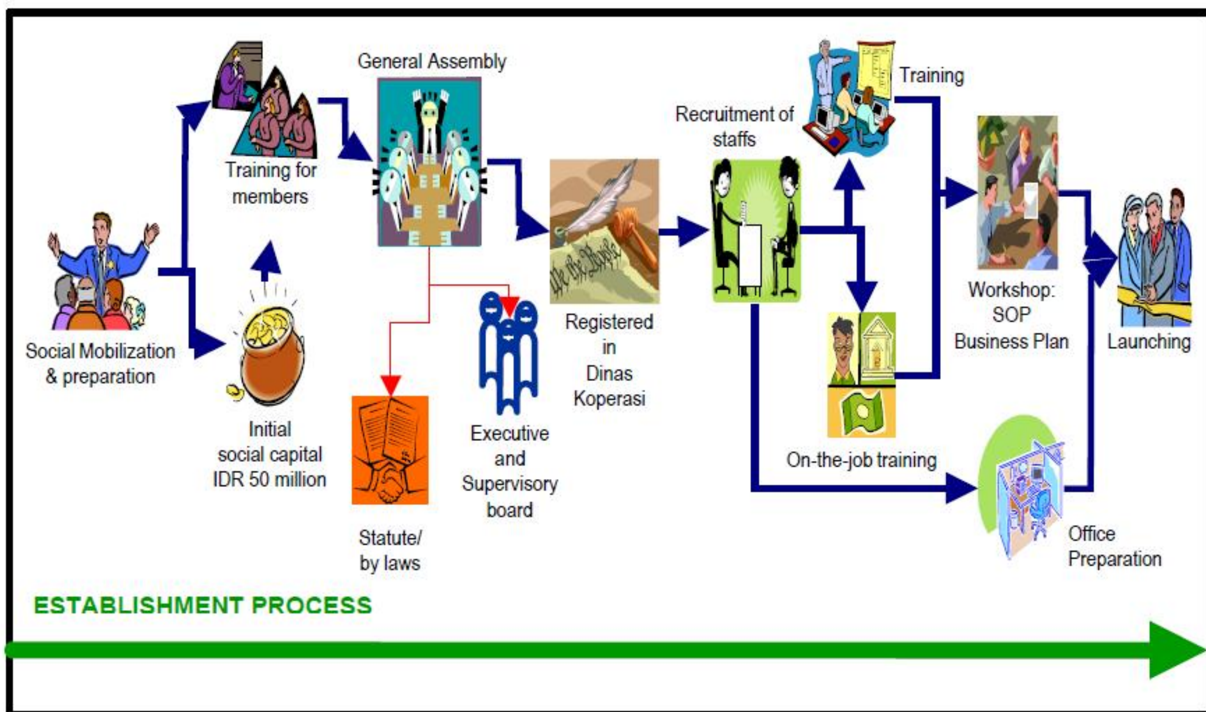


Figure 6: Flow Establishment of BQ under GTZ administration (Utama 2006, 9)



Bibliography

Antonio, Muhammad Syafii. "Islamic Microfinance Initiatives to Enhance Small and Medium Sized Enterprises." In *Expressing Islam: Religious Life & Politics in Indonesia*, by Greg Fealy and Sally White, 251-266. Panjang: Institute of Southeast Asian Studies, 2008.

Arulpragasam, Jehan, and Vivi Alatas. *Making the New Indonesia Work for the Poor.* Report, New York: The World Bank, 2006.

Asian Development Bank. *Microenterprise Development: Not by Credit Alone.* Manilla: Asian Development Bank, 1997.

Brugnoni, Alberto G. "Applying Koranic Thinking to Microfinance." *Islamic Banking and Finance*, 18 ed.: 21-23.

Chowdhry, Sajjad. *Creating an Islamic Microfinance Model - The Missing Dimension.* November 18, 2008. http://www.dinarstandard.com/finance/MicroFinance111806.htm (accessed December 3, 2009).

Dhumale, Rahul, and Amelia Sapcanin. *An Application of Islamic Banking Principles to Microfinance.* Study by the Regional Bureau of Arab States, New York: United Nations Development Programme, in cooperation with the MENA region World Bank, 1999.

El Hawary, Dahlia, and Wafik Grais. *The Compatibility of Islamic Financial Services and Microfinance: A Little-Explored Avenue for Expanding Outreach.* July 2005. http://www.uncdf.org/english/microfinance/pubs/newsletter/pages/2005_07/news_compatibility.php (accessed December 3, 2009).

International Co-operative Alliance. *Statement on the Co-operative Identity.* May 26, 2007. http://www.ica.coop/coop/principles.html (accessed December 2009).

Obaidullah, Mohammed. *Introduction to Islamic Microfinance.* New Delhi: IBF Net Limited, 2008.

Obaidullah, Mohammed, and Tariqullah Khan. *Islamic Microfinance Development: Challenges and Initiatives.* Policy Dialogue Paper, Jeddah: King Fahd National Library, 2008.

Sachs, Jeffrey. *The End of Poverty: The Economic Possibilities for Our Time.* Chicago: Penguin Press, 2005.

Sakai, Minako. "Community Development Through Islamic Microfinance: Serving the Financial Needs of the Poor in a Viable Way." In *Expressing Islam: Religious Life & Politics in Indonesia*, by Greg Fealy and Sally White, 267-285. Panjang: Institute of Southeast Asian Studies, 2008.

Seibel, Hans Dieter. "Islamic Microfinance in Indonesia: The Challenge of Institutional Diversity, Regulation, and Supervision." *Journal of Social Issues in Southeast Asia*, 2008: 86-103.

Seibel, Hans Dieter, and Wahyu Dwi Agung. *Islamic Microfinance in Indonesia.* Economic Development and Employment Division Financial Systems Development Sector Project, Eschborn: Deutsche Gesellschaft fur Technische Zusammenarbeit (GTZ), 2005.

Stiglitz, Joseph. *Globalization and its Discontents.* Chicago: W. W. Norton & Company, 2003.

The United Nations. *United Nations Millennium Development Goals.* January 3, 2009. http://www.un.org/millenniumgoals/.

Todaro, P Michael, and Stephen C Smith. *Economic Development.* San Francisco: Pearson Prentice Hall, 2007.

Utama, Iman Budi. *Baitul Qurad: Reconstructing Islamic Cooperatives in Aceh Indonesia.* Advisory Report to the GTZ Economic Recovery and Microfinance Aceh, Cologne: University of Cologne Development Research Centre, 2006.

World Council of Credit Unions. *What is a Credit Union?* 2009. http://www.woccu.org/about/creditunion (accessed December 3, 2009).