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Improving the effectiveness of Islamic micro-financing Learning from BMT experience

Effectiveness of
Islamic
micro-financing

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Abstract

Purpose – The purpose of this paper is to suggest a way to improve the effectiveness of Islamic micro-financing in Indonesia.

Design/methodology/approach – The approach taken to measure and evaluate the effectiveness of micro-financing is to point out the change of micro-enterprises' business performance and then develop a concept based on the research findings and literature review.

Findings – The implementation of Islamic micro-financing, which was preceded by selection process of micro-enterprises and also accompanied by business control, incentive system, and construct good relationship, is effective in developing micro-enterprises and improving the household income. However, an integrated program as an effort to improve the effectiveness of Islamic micro-financing is still necessary.

Practical implications – Micro-enterprises' development requires not only provision of financing in an interest free-based system, but it also needs the provision of other services. For the purpose of holistic approach for micro-enterprises' development and poverty alleviation, the spiritual development, especially via internalizing Islamic moral values in an entrepreneur's consciousness, is also necessary. In addition, poverty alleviation will be successful if Islamic financing is conducted in many areas, and the government takes part in this program.

Originality/value – This paper shows how, in the Islamic perspective, spiritual development is necessary in improving the effectiveness of financing.

Keywords Poverty, Islam, Indonesia, Microeconomics, Business development

Paper type Technical paper

1. Introduction

The provision of capital is expected would help micro-enterprises (MEs) to start or to strengthen their business since in general they have difficulties in obtaining fund due to the tenuous nature of their business establishment. The rate and level of success of early stages businesses would enhance the operational sophistication of MEs and increase the operational effectiveness, and lead to improve their performance. In turn it becomes a bridge to poverty alleviation. Capital is an important component for business aside from expertise of labor, other inputs and technology. Roberts and Roberts (2003) state capital is a critical element for the success of ME. In general, the necessity of capital for ME can be fulfilled by credit. According to Khandker and Faruqee (2003) credit capitalizes entrepreneurs to undertake new investment or adopt new technologies. Furthermore, according to Ramzan (1997) the credit availability facilitates the establishment of MEs, which in turn generates employment opportunities for the poor and also enhances their productivity. The resulting growth in income enables the poor to finance the necessities of life, like food, health, and education. The growth and promotion of MEs thus alleviate poverty and promote development. Khan (2008) states that the access to credit creates a virtuous cycle of



investment and increased income that breaks vicious cycle of poverty in which many poor people are trapped. The infusion of credit creates opportunities for self-employment for poor borrowers and that in this turn augments their income and leads to increased consumption and investment. It means that the existence of microfinance institution (MFI) – which provides a broad range of financial services to low-income MEs and households – is necessary.

For allaying financing difficulties of MEs in obtaining fund, most of the developing countries (mostly by non-governmental organization) set up special institutions (MFIs) to disburse concessionary loans. But most of them charge high interest rate[1]. It clears that the appearance of many MFIs gives opportunities to MEs in obtaining additional capital. Nevertheless, giving loans with very high interest rate does not assist them to develop their business and enhance their income. Charging high interest rate precisely will be burdensome for them because they must repay their loan plus high interest regardless they obtain profit or loss. It is unjust, selfish, and moreover, it involves exploitation. Therefore, the alternative solution to help them is necessary.

The prohibition of interest (*riba*) in Islam constitutes a way out to avoid exploitation as well as to establish justice. According to Siddiqi (1981) the main reason why Islam abolishes interest is that it is, in essence, oppression through exploitation. Furthermore, Mannan (1986) reveals that interest uproots the very foundation of humanity, mutual help and sympathy and creates selfishness in men. According to Ramzan (1997) the rationale of prohibition is based on the fact that it assures a fixed return to the financier while the borrower is left to bear the entire business risk. Islam wants to promote justice and equity. Justice demands that the financier shares risk with borrower if he/she wishes to earn the profit. Furthermore Khan (1988) reveals that the elimination of *riba* contributes to social justice. Thus, it is obligatory upon every human being to eliminate the element of *riba* from any kind of transaction. It means that every transaction is required to be free from *riba*. MEs development (for poverty alleviation) needs a just provision of capital which balances the importance of MFI and MEs. The Islamic ethical principles not only determine individual choice and collective one, but also provide a principle of integrating the two (Naqvi, 1981). The teaching of Islam establishes the spirit of brotherhood as the primary objective of transacting parties (Billah, 2003). It is an important foundation for MEs development and poverty alleviation, because it is expected to give mutual benefit especially among the involved parties. Then, the establishment of Islamic microfinance institution (IMFI) is not only useful for liberating the society from *riba* system and establishing justice, but also be expected becomes a bridge for MEs development and poverty alleviation.

As the effort to bring into reality the teaching of Islam, many Muslim countries try to introduce IMFI in interest free-based system to provide capital for MEs[2]. Evidence shows that the provision of capital (in interest free-based system[3]) by IMFI in Indonesia – that is *Baitul Mal Wat Tamwil* (BMT)[4] – is able to improve the business performance of MEs significantly (effective) through the increasing of business income, profit, and asset (Widiyanto and Ismail, 2007). It constitutes important evidence the success of Islamic micro-financing in improving the business performance of MEs. Therefore, the objective of this paper is to develop the concept of improving the effectiveness of Islamic micro-financing learns from BMT experience.

This paper is divided into five sections. Section 2 discusses BMT financing and the business performance of MEs. Section 3 discusses what can be learned from BMT experience. Section 4 discusses improving the effectiveness of financing for MEs development and poverty alleviation. Section 5 is conclusion.

2. BMT financing and the business performance of MEs

The study of BMT financing utilizes 60 BMTs and 204 MEs as samples, which are located in Central Java, Indonesia. It is selected based on area sampling frame in which different geographic regions were selected to create a good sample of the various conditions of large Central Java province.

2.1 BMT activities

BMT constitutes IMFI (operates based on interest free-based system) which is established by local prominent figures of the society. Conceptually, BMT has dual functions – as a *Baitut Tamwil* and as a *Baitul Maal*. It means that BMT has dual missions – business and social. The business mission of BMT is functioning as a financial intermediation which provides financial services such as savings[5] and ME financing[6]. While the social missions of BMT are as *amil* (collect and distribute *Zakah*), collect and distribute *Infaq* and *Shadaqah* and provide money on *qard al-hasan* financing.

2.2 Business sectors of the BMT participants

The participants of BMT financing run business in different sectors – trading, services, agriculture, and production (home industries). Several of them run business not only in one sector – but two or three sectors – such as combination of trading and services, trading and agriculture, trading and services and agriculture, trading and services and production, trading and agriculture and production. Nevertheless, BMTs dispose to select the participants who run the business in trading sector rather than the ones in service, agricultural and home industrial sectors. It may be based on the consideration that the business turnover of trading sector is faster than the others, or less risky than the others. Table I shows several examples of the types of business (according to business sectors) handled by the participants of BMT financing. The second, third, fourth and fifth column of Table I show the examples of the types of businesses in trading, service, agricultural and production sectors, respectively. The progress of the participant number of BMT financing increased significantly. The

S. No.	Trading sector	Services sector	Agriculture sector	Production sector/ home industry
1.	Meatballs	Beauty parlor	Rice	Soybean curd
2.	Agriculture products	Food catering	Chicken livestock	Fermented soybean cake
3.	Nine basic needs	Computer rental	Cow livestock	Furniture
4.	Cake	Computer repair	Fisherman	Chips
5.	Medicinal herbs	Motorcycle transportation	Quail livestock	Clothes
6.	Cigarette	Motorcycle workshop	Rabbit livestock	Paving
7.	Flower	Tire repair	Crops planted as 2d crop in dry season	Noodle
8.	Snacks	Photography	Corn	Wafer
9.	Food stall	Printing house	Potato	Clothes for baby
10.	Java sugar	Rice mill		
11.	Vegetables	Lathe workshop		
12.	Fruits	Welder		

Source: Primary data

Table I.
The forms of types of
business by sectors

participant number of BMT financing per BMT in 2002 on average is 482 participants and increased to 847 participants in 2005. Roughly from 2002 to 2005 the participant number of BMT financing increased by 76 percent. This figure points out that BMTs have a big role in serving the society to develop the people's economy as well as to liberate the society from interest system.

2.3 Effectiveness of financing

The effectiveness of BMT financing (as measured by paired sample *t*-test) in developing MEs has been evaluated by pointing out the change of business performance i.e. business income and profit by comparing the mean of these indicators at the first time the MEs joint BMTs (first condition) and when the research was conducted (second condition). Table II shows the paired sample *t*-test of Islamic micro-financing practiced by over all the BMTs is able to enhance business performance of MEs.

The business performance of MEs (business income, profit, and asset) increases significantly after they join to BMT financing. Initially, when they joined BMT for the first time, the mean business income, profit, and asset of MEs are Rp. 3,434,120.10, Rp. 803,379.90, and Rp. 10,002,598.04, respectively, and in the last condition (when the research was conducted) it increased to Rp. 7,742,279.41, Rp. 1,877,972.79, and Rp. 25,854,341.67, respectively.

The rate of non-performing financing (NPF) or the rate of repayment also constitutes an important indicator of the effectiveness of financing. The low rate of NPF or the high rate of repayment indicates that BMT financing is effective in developing MEs. MEs that are able to develop their business will obtain profit and furthermore they are able to repay the capital as well as the share of profit or mark-up to BMTs. Overall, Table III shows that the rate of NPF of BMTs (2002-2005) is still less than 5 percent or the rate of repayment greater than 95 percent. It indicates that BMT financing is still effective.

The above result indicates that BMT financing is able to improve business performance of MEs effectively. It constitutes evidence that Islamic micro-financing is

Table II.
The summary of the paired samples *t* test of business income, profit, and asset of micro-enterprises (Rp)

Indicators	Mean 1	Mean 2	Differences of mean	<i>t</i> value
Business income 1 & 2	3,434,120.10	7,742,279.41	4,308,159.3	7.602*
Profit 1 & 2	803,379.90	1,877,972.79	1,047,592.9	8.418*
Business Asset 1 & 2	10,002,598.04	25,854,341.67	15,581,744.0	6.629*

Notes: 1 and 2 represent the first and last condition of the MEs joint to BMTs, respectively; * represents 0.01 significance level

Table III.
Descriptive statistics of NPF 2002-2005

	<i>n</i>	Minimum (%)	Maximum (%)	Mean (%)	Std. deviation
NPF 2002	51	0.19	15.10	3.95	3.19
NPF 2003	52	0.16	24.61	4.54	4.62
NPF 2004	56	0.15	17.10	4.03	3.84
NPF 2005	57	0.11	17.90	3.54	3.59

Source: Primary data

applicable for developing MEs. This is in accordance with the finding of Ramzan (1997) in which Islamic financing (profit-loss sharing) has been successful in catering the financing needs of MEs.

In addition, BMT financing does not only improve the business performance of MEs, but also enhance the household income of MEs. The household income of MEs at the first time they joined BMTs is different significantly from the last condition when survey was conducted. That is on average the household income increased from Rp. 893,041.67 to |Rp. 2,150,813.7 per month. It indicates that the household income of MEs on average increased more than 100 percent. Furthermore, the increase of household income is accompanied by the increase of saving, ability to fulfill the basic requirement, ability to pay school fee for their children and to pay the cost of medical treatment of household members and, moreover, the increase of the religious activity. It means that Islamic micro-financing is potential for poverty alleviation.

The further finding indicates that the selection process of MEs; business control; incentive system; and construct good relationship constitute the important factors which cannot be ignored in achieving the effectiveness of BMT financing.

3. What can be learned from BMT experience?

The finding shows that the implementation of Islamic micro-financing which is preceded by selection process of MEs and also accompanied by business control; incentive system; and construct good relationship (cooperative) is effective in developing MEs. So, what can be learned from BMT experience?

3.1 Selection process

The basic idea of the selection of MEs (the participants of Islamic financing) is to obtain the minimum standards of legal capacity – they must have legal capacity to enter into a contract[7]. It is related to the liability of their loan. BMT has conducted the selection process of MEs before they obtain fund. It embraces: administrative selection, interview, and feasibility study (including visitation to check the business condition). The basic criteria of selection include: the credibility (honesty/*akhlaq*); capability in running business (skill); business experience; collateral; and business worthiness. Feasibility study also constitutes an important aspect in selecting MEs, since based on this activity, BMTs can determine the feasible MEs which have real business value and avoid the fictitious ones. The selection of MEs especially for *mudharabah* financing is conducted more selectively rather than the others. The capital owners have the right to select the best business partners who are desirable (profitable and believable[8]). According to Mansuri (2006), in the case of *mudharabah* financing, the partners must have legal capacity to enter into contract. It includes competence to develop a principal – agent relationship. This requires that none of the parties should be insane or minor or placed under interdiction because of insolvency or weaknesses of intellect. Therefore, in *mudharabah* contracts, the personal qualities and the characteristics of entrepreneur are vital criteria in relation to the decision by the provider of funds to accept or reject the project (Khalil *et al.*, 2002). Islam demands specific codes of behavior to be followed.

Based on sound feasibility study, the profitability of the business would be protected, so that all parties are expected to enjoy the benefit of the business. By selecting the believable business partner (*amanah*[9]), the principles of justice can be maintained. It means that the possibility of the business partner not paying his debt can be reduced. It is a part of the Islamic system. For this purpose, the selection

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26,1 (screening) of the business partner (agent) is needed to ensure the success of the business. Nevertheless, the basic criteria of the selection of MEs need to be differentiated according to the type of financing, since the level of competence of each type of financing is different (Table IV).

70 **3.2 Business control**
Business control reduces the deviation of the use of fund by MEs for other purposes. It is very useful for improving the effectiveness of financing. The result shows that only 4.41 percent of MEs use the fund from BMTs for purposes outside the business. The advantage of Islamic financing – especially for *murabahah* or *bai’u bithaman ajil* and *ijarah* financing – is that this financing can reduce the deviation of the use of capital to other purposes since MEs receive the capital in the form of product and not in the form of fund. Loan fund will be spent on the purposes for which they are intended. In general, business control can be conducted through periodical monitoring of the business progress via direct visitation. In the case of *mudharabah* financing, the business control can be conducted via periodical control of the business record and also direct visitation. According to Chapra (1985) a careful evaluation of the projects is required by profit-and-loss sharing followed by continuing close relationship that may tend to minimize cases needing such treatment. Cross check among the participants of Islamic financing can also be conducted. So, the grouping of the participants (to be acquainted with other participants, exchange of information, communication, and cooperation) in each area is strongly recommended. It is useful to facilitate the process of business control or process of monitoring[10].

3.3 Incentive system of good repayment
To reduce the NPF, most BMT provide incentive to the MEs if they achieve good performance in their repayment, such as giving mark-up or profit payment discount, parcel, souvenir, scholarship for their children, add their savings and enhance the ceiling of financing. Giving incentive to the MEs which achieve good performance in their repayment motivates the MEs to improve their business so that they can fully repay their loan on time without postponement. It contributes benefit to all parties (financer and MEs) especially for maintaining the sustainability of Islamic financing and MEs continue and develop their business. Otherwise, punishment to the participant (who is always in arrears) also be conducted as prevention[11].

Type of financing	1 Administrative requirement	2 Credibility/ Ahklaq	3 Capability/ skill	4 Business experience	5 Type of business	6 Business worthiness	7 Collateral
Mudharabah	SN	SN	SN	SN	SN	SN	NN
Musarakah	SN	SN	SN	SN	SN	SN	NN
Murabahah	SN	N	N	N	N	N	N
Bai’u bithaman ajil	SN	N	N	N	N	N	N
Ijarah	SN	N	N	N	N	NN	NN
Qard al-hasan	SN	N	N	NN	NN	NN	NN

Table IV.
Basic criteria of MEs selection

Notes: SN = strongly needed, N = needed, NN = no need

3.4 Construct good relationship (cooperative)

Most BMTs also establish good relationship to the MEs to reduce the NPF through visitation (friendship) on wedding parties, visit during a wake, personal approach, advice or assistance, religious activities and building up of character (*akhlaq*). The ability of financier in constructing good relationship with their participants is very necessary so that the financier is able to easily and accurately access the business information of the participants. The ease and accuracy of the business information facilitate the financier in controlling the progress of business to reduce principal agent problems as well as in solving the business problem of the participants. In sum, constructing good relationship with the participants helps financier in reducing the rate of NPF as well as improving the effectiveness of Islamic financing.

Developing a good relationship in the form of business advice or assistance, religious activities and building up of the character to the MEs is beneficial in increasing business performance. Business advice helps the MEs in solving their business problems as well as developing their business. Nevertheless, it still depends on the quality of the business advice which has been accepted. Furthermore, religious activities contribute in increasing self-reliance which encourages MEs to improve their business performance. Religious moral values make a decisive impact on human motivation to work hard when moral values become deeply internalized in man's consciousness so that both the mind and the soul take on a quiet but magical luminosity. Building up of the character (*akhlaq*) of the micro-entrepreneurs – so that they are able to change their bad to good behavior such as to change wasteful to thrift behavior and the inclination to postpone the loan repayment – will also help MEs in improving their business performance via improving efficiency as well as accelerating the loan repayment. The change of individual behavior to a better condition enables the micro-entrepreneurs to improve their quality of business as well as to reduce the rate of NPF.

4. Improving the effectiveness of financing for ME development and poverty alleviation

In terms of MEs development, Morris (1998) states that the interest is both with enhancing birth rates and improving the rate and level of success of early stages business. It includes activities that enhance the operational sophistication of the enterprise, increase the operational effectiveness, and lead to the improvement of performance, and for many, growth. The end result may well be to foster the movement of many of these enterprise out of the ME category. It means that, MEs development is potential for poverty alleviation. There are several activities which may be useful for this purpose, among others are: giving credit (financing) and/or giving classes to poor people to help them to start or to strengthen their businesses (Schreiner and Woller, 2003), building self-esteem and self-reliance, encouraging autonomy, and creating community atmosphere (Geroy *et al.*, 1997). Furthermore, Goldmark (2001) reveals that the future of ME development, however, contemplates an ever wider range of available services, both financial and non-financial, through which small business owners can build linkages to larger business and more profitable markets. Services that directly target the business owners' activities may include training, technology access, marketing assistance, business advice, monitoring, and information. While Friedman (2001) focuses the ME development on the assets, talents, and skill of individuals and channel them into small business ownership. The previous concepts indicate that MEs development is not only enough by providing financial services, but also needs the wider range of other services (non-financial) which is useful for improving the

effectiveness of financing. In other words, in terms of MEs development (as a means of poverty alleviation), the availability a wider range of non-financial services to improve the effectiveness of financing is necessary. The improving effectiveness of financing is not only useful for MEs development and poverty alleviation, but also gives benefit to IMF by reducing the risk of business and sustainability of the program.

In Islamic perspective, for the perfection purpose of the previous concepts, the spiritual development especially via internalizing Islamic moral value in entrepreneur's consciousness (*akhlaq*) is also necessary. It is aimed to build up honesty, discipline, spirit, diligence, patience, piety, social responsibility, and arouse awareness, or to change the bad to good behavior. For the purpose of poverty alleviation, it is needed. Since, poverty not only is an economic issue, but also has moral, social and political dimensions (Naqvi, 2003). Therefore, poverty alleviation program in Muslim societies should be multi-dimensional to implement Islam's moral vision. In sum, MEs development and poverty alleviation need an integrated program – the provision of financial and non-financial services (including spiritual development via internalizing Islamic moral value).

In addition, poverty alleviation (via MEs development) will be successful if Islamic financing is conducted in many areas (massive), and the government takes part in (or support) this program. The provision of Islamic micro-financing only for a small people in a small area is not sufficient for poverty alleviation. Furthermore, the poverty alleviation program will face difficulties if the government does not take a role in this program. Then, the political will of government is necessary – that is by making regulation which encourages the Islamic micro-financing program. Providing rural infrastructure is also an essential requirement of favorable environment for MEs development. Therefore, the process of improving the effectiveness of financing (as a means of MEs development and poverty alleviation) can be summarized as shown in Figure 1.

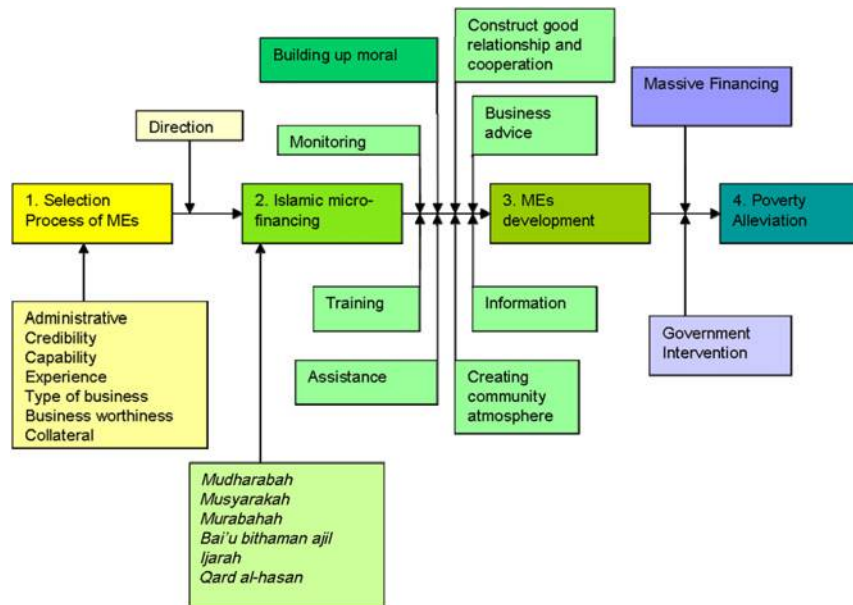


Figure 1.
The process of improving the effectiveness of financing as a means of MEs development and poverty alleviation

5. Conclusions

The provision of capital is expected would help micro-enterprises (MEs) to start or to strengthen their business since in general they have difficulties in obtaining fund due to the tenuous nature of their business establishment. Nevertheless, giving loans with very high interest rate does not assist them and precisely will be burdensome for them. It is unjust, selfish, and moreover, it involves exploitation. Therefore, MEs development (for poverty alleviation) needs a just provision of capital which balances the importance of MFI and MEs. Furthermore, the spirit of brotherhood constitutes an important foundation for MEs development and poverty alleviation.

BMT financing is able to improve business performance and the household income of MEs effectively. It means that Islamic micro-financing is potential for poverty alleviation. The finding indicates that the selection process of ME; business control; incentive system; and construct good relationship constitute the important factors which cannot be ignored in achieving the effectiveness of BMT financing. By selecting the believable business partner (*amanah*), the principles of justice can be maintained and the possibility of the business partner not paying his debt can be reduced as well as to ensure the success of the business. Nevertheless, the basic criteria of the selection of MEs need to be differentiated according to the type of financing.

Business control reduces the deviation of the use of fund by MEs for other purposes. It is very useful for improving the effectiveness of financing. It can be conducted through periodical monitoring of the business progress via direct visitation. For this purpose, cross check among the participants of Islamic financing can also be conducted, and the grouping of the participants in each area is strongly recommended.

Constructing good relationship with their participants is very necessary. It helps financier in reducing the rate of NPF as well as improving the effectiveness of Islamic financing. Developing a good relationship in the form of business advice or assistance, religious activities and building up of the character (*akhlaq*) to the entrepreneurs is beneficial in increasing business performance.

In terms of MEs development (as a means of poverty alleviation), the availability of a wider range of non-financial services to improve the effectiveness of financing is necessary. It is not only useful for MEs development and poverty alleviation, but also gives benefit to IMFIs by reducing the risk of business and sustainability of the program. MEs development and poverty alleviation need an integrated program – the provision of financial and non-financial services (including spiritual development via internalizing Islamic moral value). Furthermore, poverty alleviation will be successful if Islamic financing is conducted in many areas (massive), and the government takes part in (or supports) this program.

Notes

1. For example, Bancosol in Bolivia charges interest: 54 percent per annum, Enterprise Mentor International in the USA: 30 percent per annum, Grameen Bank: 22.45 percent per annum (Alam and Miyagi, 2004), Other MFIs in Bangladesh: 18-30 per cent per annum (Alamgir, 2000).
2. For example, Ar-Rahn (Malaysia), *Baitul mal wat tamwil*/BMT (Indonesia), Interest Free Micro-credit Programs/IMCP (Pakistan), Islamic Relief (Bosnia, Herzegovina, Kosovo, Pakiastan, and Sudan).
3. For example, *musyarakah*, *mudharabah*, *murabahah*, *bai'u bithaman ajil*, *ijarah*, and *qard al-hasan* financing.

4. BMT is Islamic microfinance institution (non-governmental organization) which was established by local community and generally it has cooperative corporate body.
5. For example: *mudharabah* savings, pilgrim savings, religious offering savings (at rites celebrating *idul adha*), farmer savings, educational savings, pension savings, etc.
6. It includes *mudharabah*, *musyarakah*, *murabahah*, *bai'u bithaman ajil*, *ijarah* and *qard al-hasan* financing.
7. Capacity is a quality which makes a person qualified for acquiring rights and undertaking duties and responsibilities (Kharofa, 2004).
8. Affandi (2002) suggests that in the context of partnership, choosing the right partners is needed, based on their piety as well as high morality and good behavior.
9. According to Sulaiman (1981) *mudharabah* is undertaken based on the trust (*amanah*) of the *rabb-ul mal* to the *mudharib* about his strength to hold the trust and his capability.
10. The forming group is not aimed to form the social collateral and ensure the debt repayment which is suggested by Ahmed (2002b). We argue that the social collateral and ensure the debt repayment can be formed via building consciousness of *Zakah*, *Infaq* and *Shadaqah*.
11. For example, BMT did not enhance the ceiling of financing for next period, or continue the contract.

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