ROLES OF ISLAMIC MICROFINANCE INSTITUTIONS IN IMPROVING FINANCIAL INCLUSION IN INDONESIA: EMPIRICAL EVIDENCE FROM *BAITUL MAAL WA TAMWIL*

BY

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ABSTRACT

Indonesia, which has the biggest Muslim population in the world, is well-known for its microfinance institutions (MFIs) that serve the lower-middle class sector. With approximately 56.5 million Micro, Small and Medium Enterprises (MSME), the sector contributed more than 60% of Gross Domestic Product (GDP) in 2018. However, many of the MSMEs do not have adequate access to financial services, especially in rural areas. Moreover, 8.77% of Indonesians are at the bottom of the economic pyramid (BOP). The purpose of this study is to investigate the roles of Islamic microfinance institutions (IMFIs) in improving financial inclusion in Indonesia by taking six geographical areas, namely, Jakarta, Bogor, Depok, Tangerang and Bekasi (JABODETABEK); West Java; Central Java; East Java; Yogyakarta and Lampung province as samples. In this regard, only managers of the IMFIs are taken as respondents since they are the decision makers and they understand and appreciate the missions of the IMFIs, thus are practically responsible for achieving the IMFIs objectives by anticipating issues or regulatory changes. A total of 100 managers of *Baitulmaal Wa Tamwil* (BMTs), which registered with Shariah Cooperative Centre (INKOPSYAH) are interviewed. Two instruments were developed to collect data. The first instrument is a questionnaire related to conceptual framework of this study which is based on the research objectives, as well as adapting from previous studies. The second one is an in-depth interview to outline data related to the model design. The findings of this research are divided into four categories: first, the current conditions and issues relating to financial inclusion; second, the roles of IMFIs in improving financial inclusion by increasing wealth and alleviating poverty; third, the determinants that influence the roles of IMFIs in improving financial inclusion; and the last, providing the most effective strategies of IMFIs to improve financial inclusion. This research provides important inputs to decision-making of the IMFIs in efforts to optimize their roles in improving financial inclusion in Indonesia. Finally, this research recommends a program development to integrate IMFIs in collaboration with bank and association of BMTs for providing microfinance services.

خلاصة البحث

أندونيسيا، والتي تضم أكبر عدد سكاني مسلم في العالم، مشهورة بنظامها للتمويل الأصغر على نطاق واسع. يوجد في الدولة ما يقرب من 56.5 مليون شركة صغيرة ومتناهية الصغر ساهمت بأكثر من 60% من الناتج المحلي الإجمالي للبلاد في عام 2018. ومع ذلك، فإن العديد من الشركات الصغيرة والمتوسطة لا تتمتع بوصول كاف إلى الخدمات المالية، وخاصة في المناطق الريفية. بالإضافة إلى ذلك، يقع 8.77% من سكان أندونيسيا في أسفل الهرم الاقتصادي. وعليه فإن هذه الدراسة تهدف إلى استكشاف دور مؤسسات التمويل الصغير والأصغر الإسلامية في تحسين الشمول المالي في أندونيسيا من خلال دراسة عشر مناطق جغرافية وهي: جاكرتا، وبوجور، وديبوك وتانجير انج، وبيكاسي، جاوة الغربية، جاوة الوسطة، جاوة الشرقية، يوجياكرتا، ومقاطعة لامبونج. في هذا الخصوص، تم استهداف مديري مؤسسات التمويل الصغير والأصغر الإسلامية فقط كونهم هم صانعوا القرار والأكثر دراية بمهام مؤسسات التمويل هذه، وبالتالي فهم المسؤولون عملياً عن تحقيق أهداف مؤسساتهم. تمت مقابلة 100 مدير من بيت المال والتمويل المسجلين لدى مركز الشريعة التعاوني (INKOPSYAH). تم تطوير أداتين لجمع البيانات. الأداة الأولى عبارة عن استبيان يتعلق بالإطار المفاهيمي لهذه الدراسة مبني على أهداف البحث. والأداة الثانة عبارة عن مقابلات عميقة لتحديد البيانات المتعلقة بتصميم النموذج. تم تقسيم نتائج هذا البحث إلى أربع فئات: الأولى، الظروف والقضايا الحالية المتعلقة بالشمول المالي: الثانية، دور مؤسسات التمويل الصغير والأصغر في تحسين الشمول المالي من خلال رفع معدل الثروة وتخفيف نسب الفقر: الثالثة، المحددات التي تؤثر على دور مؤسسات التمويل الصغير والأصغر الإسلامية في تحسين الشمول المالي: وأخيراً، تقديم الإستراتيجيات الأكثر فعالية لمؤسسات التمويل الصغير والأصغر الإسلامية لتحسين الشمول المالي. يقدم هذا البحث مدخلات مهمة في إتخاذ القرارات في مؤسسات التمويل الصغير الإسلامية ضمن الجهود المبذولة لتحسين أدوارها في تعزيز الشمول المالي في أندونيسيا.

APPROVAL PAGE

The thesis of Adhitya Ginanjar has been approved by the following:

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DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Adhitya Ginanjar

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LIST OF ABBREVIATIONS

AFI	Alliance for Financial Inclusion
NGO	Non-Government Organization
GO	Government Organization
SMEs	Small Medium Enterprises
MFIs	Micro Finance Institutions
IMFIs	Islamic Micro Finance Institutions
BMT	*Baitulmaal Wa Tamwil*
IT	Information Technology
JABODETABEK	*Jakarta Bogor Depok Tangerang Bekasi*
INKOPSYAH	*Induk Koperasi Syariah*
APEX BMT	Association of BMT
AML/CFT	Anti-Money Laundering/Combating Financing of Terrorism
MDGs	Millennium Development Goals
SDGs	Sustainability Development Goals
CSR	Corporate Social Responsibility
GDP	Gross Domestic Product
BOP	Below of Poverty Line
MSMEs	Micro Small Medium Enterprises
BRI	*Bank Rakyat Indonesia*
BKD	*Badan Kredit Desa*
LDKP	*Lembaga Dana Kredit Pedesaan*
SNKI	*Strategi Nasional Keuangan Inklusi*
OJK	*Otoritas Jasa Keuangan*
PLS	Partial Least Square
SEM	Structured Equation Modeling
CD	Community Development
FE	Financial Education
IV	Islamic Value
PL	Financial Policies
CB-SEM	Covariance Based Structured Equation Modeling
SD	Standard Deviation
MN	Managerial
SU	Subsidize
EX	Business Expansion
CO	Consumption
AVE	Average Variance Extracted
CR	Composite Reliability
PL	BMT Policies
FI	Poverty Alleviation
PO	Financial Inclusion
VE	Variance Extracted
R^2	R-squared Value

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Financial inclusion has gained important attention since the early 2000s due to the fact that it has a direct correlation with poverty alleviations. World Bank (2014) defined the goals of financial inclusion as accessing a full range of financial services for households including savings or deposit services, payment and transfer services, and credits and insurance. Alfred Hannig, the Executive Director of Alliance for Financial Inclusion (AFI), a Non-Government Organization (NGO) which was established and supported by World Bank, highlighted that *"financial inclusion is no longer a fringe subject, it is now recognized as an important part of the mainstream thinking on economic development based on government will"* Therefore, financial inclusion has motivated a whole countries, particularly developing countries towards the worldwide financial reform program and develops an uniqueness financial interest for regulators, researchers and practitioners (World Bank, 2014).

Referring to AFI (2010), financial inclusion can be categorized into four components namely *access*, *quality*, *usage* and *welfare*. Access emphasizes the ability to utilize financial services; quality includes consumer experiences shown in opinion and attitude; usage focuses on permanence and the depth of services or products of the financial sector; while welfare measures the impact of products or services to consumer. All the four components need to be emphasized in the financial inclusion programs to increase the percentages of population that have access to formal financial services and effectively reduce the poverty.

Arun and Kamath (2015) argued that financial inclusion has become a global interest especially in developing countries. The lack of access to formal financial services by labor is a genuine global policy concern. The study showed that culture influences customers to understand banking products and access financial services. The study also found that financial inclusion policies enhanced digital access to finance by ensuring sustainability of financial service delivery and educating financial literacy to decrease cultural and language gaps in rural areas. Moreover, financial inclusion generally could be implemented to remote area in enhancing financial access to the poor.

In addition, several firms in the developing countries, containing majority of small and medium enterprises (SMEs), operated in the sector of informal economy. As a result, the informal firms faced a variability of limitations, which make it inflexible for them to grow and do business. Furthermore, lack of financial services is often mentioned as the main operational constraint Farazi (2014) noted that there are significant characteristics of informal firms that are associated with the higher use of financial services. For instance, Islamic Microfinance Institutions (IMFIs) is one of microfinance institutions that give financial services to the poor. These financial services could be given to private or small firms with the aim to alleviate poverty. Worldwide financial services are only available to a minor percentage of the population. While financial sectors are increasing in term of assets, these assets are determined in the hands of few people or firms. An inclusive financial sector that provides the massive majority of the population a sustainable access of financial services (Imboden, 2005).

Currently, Islamic microfinance has become an effective tool to fight poverty. Hassan, Kumar and Sinclair (2015) mentioned that a financial inclusion program is very important to the poor in order to access financial services and alleviate poverty. In the case of Indonesia, the roles of IMFIs are effective to enhance financial inclusion programs. However, as a conventional microfinance, it has obstacles that constrain its full utilization as a poverty reduction mechanism. The study also suggested a model of design and developed an Islamic microfinance product to cooperate with Islamic banks in channeling and executing funds. Hence, Islamic banks could incorporate Islamic microfinance products as an alternative poverty reduction mechanism.

The value of Islamic microfinance is not to provide financial services to only the poor but also to the poorest or unprivileged people in the un-bankable sector of the economy. This is regularly funded by Islamic social endowment sector namely; *Infaq, Sadaqah* and *Zakah*). Islamic micro financing was delivered by Islamic Microfinance institution to the poor that is fundamentally distributed with an interest-free in compliance with the Islamic financing principles (Wulandari and Kassim, 2016).

Bansal (2014) stated that financial inclusion is not only about expanding financial services to the people in remote area. However, it also comprises distributing a several of financial services containing credit facility, insurance, and settlement products. The study also mentioned that government delivers financial inclusion predominantly deal with increasing branches, launching special institutions such as Rural Regional Banks (RRB) and cooperative banks, and creating the instructed micro credit targets. However, in its implementation, these approaches showed diminishing returns.

Islamic banking and microfinance in Indonesia was happening in 1993 with the launching of Bank Muamalat Indonesia (Saefullah, 2010). After the Islamic finance was started to be acknowledged, Islamic microfinance also occurred in the 1990s through the formal institutions namely; the Islamic banks and Islamic rural banking *(Bank*

Perkreditan Rakyat Syariah), and also non-banking institutions namely; Islamic cooperatives and IMFIs, which commonly called *Baitul Maal Wa Tamwil (BMT)* (Effendi, 2013).

Compared to other microfinance providers in Indonesia, BMT has many distinguished features. It uses a community approach that is appropriate to be implemented among the poor. It also has a special license and directly administered by the Ministry of Cooperative and Small Medium Enterprises (Masyita and Ahmed, 2013). In its later development, numerous BMT were integrated into clusters of micro-entrepreneurs such as *Kelompok Usaha Muamalat* or *Poskusma*. A Small Business Incubation Centre (PINBUK) was then established in order to consult with BMTs. Currently, more than 4000 BMTs were registered under the PINBUK (Brunsveld, 2000). Some BMTs, consisting of 87 branches in 19 provinces, received funding from Indonesia's Social Ministry with a program called BMT Kube. Additionally, Indonesia also has primary cooperative agencies called *Sharia* Cooperatives Center/*Induk Koperasi Syariah* (INKOPSYAH). It organizes 481 BMTs in Indonesia, which mostly are in Jakarta, Java, Sumatera, Sulawesi and Kalimantan. The main reasons for BMT to join INKOPSYAH are to get financial access, financial literacy training, capacity building and infrastructure building (Wulandari and Kassim, 2016).

Focusing on financial inclusion in Indonesia, the implementation of financial inclusion was primarily started in 2014 since *Otoritas Jasa Keuangan* (OJK/Financial Services Authority) issued a financial inclusion statute for commercial bank with branchless banking programs. Table 1.1 shows the progress of financial inclusion implementation with branchless banking program in Indonesia. In particular, BMTs have proofed their commitment in alleviating poverty. Therefore, this research investigated the roles of Islamic microfinance institutions in improving financial inclusion with their ability to reduce poverty and increase wealth potentials. It is also significant to know its impact on Islamic microfinance institutions in improving financial inclusion in Indonesia.

Table 1.1: Branchless Banking Services Data in Indonesia
(As in December 2016)

No.	Information	Jun 2015	Sept 2015	Dec 2015	March 2016	Jun 2016	Sept 2016	Dec 2016
1.	Number of commercial banks	6 banks (Bank Mandiri, BRI, BNI, BTN, BTPN, BCA)	6 banks	7 banks (+ BPD Kaltim)	9 conventional banks (+ Bank Sinarmas, Bank Bukopin)	12 conventional banks and 1 Sharia Bank (+ Bank Sahabat Sampoerna, BJB, Bank Jateng and BRI Syariah)	14 conventional banks and 2 sharia banks (+ Bank Danamon, Bank Riau Kepri and BTPN Syariah)	18 conventional banks and 2 sharia banks (+ Bank Artha graha, BPD Jatim, BPD NTB, BPD NTT)
2.	Number of agents/business entities	3.734 Agents	19.411 Agents	60.805 Agents	84.374 Agents	104.707 Agents	160.490 Agents	275.916 Agents
3.	Number of outstanding accounts	35.984 Customers	1.061.076 Customers	1.216.952 Customers	1.351.798 Customers	1.626.068 Customers	1.949.005 Customers	3.700.215 Customers
4.	Number of outstanding saving money	Rp.2,9 billion	Rp.40 billion	Rp.67 billion	Rp.50 billion	Rp.63 billion	Rp.93 billion	Rp.216,5 billion
5.	Number of provinces	30 Provinces	33 Provinces	34 Provinces (entire Indonesia)	34 Provinces (entire Indonesia)	34 Provinces (entire Indonesia)	34 Provinces (entire Indonesia)	34 Provinces (entire Indonesia)
6.	Number of districts/cities	211 districts /cities of 514	368 districts/ cities of 514	385 districtss /cities of 514	427 districts /cities of 514	499 districts /cities of 514	499 districts /cities of 514	507 districts /cities of 514

Source: Financial Services Authority (2017)

1.2 PROBLEM STATEMENT

While financial inclusion is a dedicated program that provides financial access to the poor in every country, it faced several issues related to Islamic microfinance programs. First, IMFIs faced the issues of competition capability in the form of providing financial services to the poor in rural area. Competition capability in finance industry can be defined as *"ability to compete"* and to survive or win the market (Ben Naceur, Barajas and Massara, 2015). Competition will increase financial performance of IMFIs such as efficiency. In this regard, efficiency reduces unnecessary cost and increases profits from the operations. Therefore, IMFIs gave higher profit to the shareholders and provided competitive margin to the borrowers (Kristen and Skowron, 2013). On the other hand, the competition between IMFIs and commercial bank is considered as not at the same level since the commercial banks have achieved its economies of scale. Commercial bank operated more efficiently than IMFIs due to supporting technology, expanding market and enhancing human resources (Shahinpoor, 2009).

Second, IMFIs also faced constraints when delivering the money to the poor. This situation happened when the borrowers cannot get the micro financing from the IMFIs due to lack of funds, manpower and IT system of BMTs. It was difficult whereas IMFIs can accept the funds from other sources namely subsidy from the government organization (GO) or non-government (NGO) (Santoso and Ahmad, 2016). Third, IMFIs also faced funding constraints around their environment namely higher margin rates, lower legal rights and political instability. They usually offer higher margin rates to their borrowers because of higher cost of fund from external sources. They also have lower legal rights to adjust their financial services to the poor. Last, political instability results in high risk in the economy that might cause volatility in the financial market and interest rate risk (Allen, Demirguc-Kunt, Klapper and Martinez Peria, 2016).

In addition, IMFIs also faced challenges of financial inclusion. Borrowers are frequently omitted from the financial banking system due to several factors (Wulandari and Kassim, 2016; Bayero, 2015). First, the borrowers generally have insufficient collateral that is compulsory by the bank. Second, the bank is tentative for financing to the poor despite the fact they are bankable. Third, the borrowers have limited sources of income to make a payment for the micro credit. Fourth, borrowers have limited access to banking system due to complex financing procedures and documentations with the additional lack of financial report experience. Fifth, the borrowers regularly were charged with high margin by the IMFIs which affect the affordability of the financing to the poor.

In the explicit case of Indonesia, the first, there is an issue of collaboration between bank and non-bank institutions. This issue could be a moderate solution to decrease competition among them. Second, supporting regulation for IMFIs to compete with commercial bank as long as there is no collaboration (Kristen and Skowron, 2013; Ben Naceur et al., 2015). Another issue is lack of IT utilization. This is because these are mostly small and medium enterprises in rural areas that do not have access to the bank (Kumar, 2013; Sharma, 2016). In fact, Allen et al. (2016), Arun and Kamath (2015) mentioned that they are predominantly *under bank* and *un-bankable* therefore they do not have access to financial services.

The next financial inclusion issue is targeting market and focusing on market for IMFIs. First, IMFIs usually have inadequate capitals and need external sources of capitals like subsidy from the government or NGO. Moreover, it would result in high cost of fund to their borrowers. Second, they also face regulation change and un-socialized policies related to their environmental businesses. For that reason, they have to adjust their businesses immediately to anticipate the regulation. Third, another issue is lack of human resources such as inadequate well-educated staff, less professional in microfinance industries, low understanding of management between managers and officers, Muslims' ambiguous between perception of *Sharia* and conventional financial services, low trust of *the poor* in Islamic microfinance, and scarcity of academic literature on Islamic microfinance Hence, it is suggested that conducting financial literacy training and educating stakeholders of IMFIs should become priority in improving financial inclusion (Shahinpoor, 2009).

Based on a preliminary research in Jakarta, Bogor, Depok, Tangerang and Bekasi (JABODETABEK) area involving five respondents of BMT's managers, this study observed five categories of the current condition and challenges of BMT in improving financial inclusion. The first condition is the reality of BMT in implementing the regulations. It is seen that the new competition has become injustice between BMT and commercial banks. The main challenge here is how BMT can adopt and re-assesses their mission to anticipate the regulations. The second condition is BMT that has a lack of capitals to expand their microfinance market. Moreover, they offered a high margin to borrowers. Thus, it makes it inefficient to compete with commercial banks. The third condition is BMT has almost no experience in financial inclusion except channeling and executing collaboration programs between BMT and commercial banks. The fourth condition is BMT is implementing a regulation that they need to survive by using a niche market in microfinance to offer their financial services in rural area. Moreover, the main challenge is how to expand their services in rural area using human resources and adopting information technology. The last condition is BMT tried to maintain organizational sustainability by joining consortium of BMT such as Sharia

Cooperatives Association or *Induk Koperasi Syariah* (INKOPSYAH) to create APEX BMT or association of BMTs for developing their existences.

This research attempts to fill the gap of literatures about the roles of IMFIs in improving financial inclusion in Indonesia. Likewise, this research will explore the current conditions and issues of IMFIs related to financial inclusion in Indonesia. Moreover, this study seeks to explore the roles of IMFIs by alleviating poverty, increasing wealth and sustainability of IMFIs. Hence, this study will examine the factors influencing IMFIs in improving financial inclusion and try to formulate the strategies that have been implemented by regulator to support roles of IMFIs in improving financial in Indonesia.

1.3 RESEARCH OBJECTIVES

Due to scarcity of research on the Roles of IMFIs in improving financial inclusion, the current study aims to achieve the following specific objectives:

1. To explore the current conditions and issues of IMFIs in improving financial inclusion in Indonesia.
2. To investigate the roles of IMFIs in improving financial inclusion in Indonesia.
3. To examine the factors influencing IMFIs in improving financial inclusion in Indonesia.
4. To formulate the strategies of IMFIs in improving financial inclusion in Indonesia.