



ASSESSING THE IMPACT OF ISLAMIC
MICROFINANCING ON CLIENTS' INCOME AND
POVERTY STATUS WITH REFERENCE TO
CLIENTS' SPIRITUALITY AND RELIGIOSITY IN
JAKARTA, INDONESIA

BY

RONALD RULINDO

A thesis submitted in fulfilment of the requirement for
the Degree of Doctor of Philosophy in Islamic Banking
and Finance

Institute of Islamic Banking and Finance
International Islamic University
Malaysia

AUGUST 2012

ABSTRACT

This study assesses the impact of Islamic microfinancing on clients' income and poverty status with reference to the clients' spirituality and religiosity. To achieve these objectives, this study collected information from 400 micro entrepreneurs, in which 360 of them were clients of Islamic Microfinance Institutions (Islamic MFIs) in Jakarta, Indonesia. The rests of them were micro entrepreneurs who shared similar characteristics with the clients who were used as control group for comparison of the impact. This study used the Multiple and Logistic Regressions to prove the hypotheses. Overall, this study found that Islamic microfinancing, as reflected by length of having Islamic microfinancing and size of financing, is able to generate positive impact on clients' income and poverty status. However, the impact cannot be obtained in the short-term, and is only significant if the poverty status is measured by using local poverty standards; the country's formal poverty standards issued by Government Agency. The impact is relatively minimum if poverty status is measured by using international poverty standards such as extreme and moderate poverty standards, or earning US\$1 and US\$2 per capita per day as adopted by the World Bank and other international organizations. This study also found that the cost of financing provides no significant impact on clients' income and poverty status. Moreover, having a better economic condition is the reason why clients who obtain *Mudharabah* and *Musharakah* financing live a better life compared to those who receive *Murabahah* financing. Another significant finding is clients who have higher spirituality level in general are found to be wealthier than those who have lower spirituality level. Religiosity level is also found as having a significant influence on clients' income and poverty status. These findings indicate that both spirituality and religiosity should be used by the Islamic MFIs in capacity building that they provide to their clients. For this purpose, the Islamic MFIs can enhance clients' knowledge on Islamic teachings particularly in terms of *aqidah*, *ibadah*, *akhlaq* and *muammalah*, and enlighten them why these matters are not only important for the *akhirah*, but also for the *dunya* purposes, including for the improvement of their business performance. With strong *aqidah* and proper *ibadah*, they will have higher spirituality level which may enhance their passion and patience. Furthermore, with proper *ibadah*, good *akhlaq* and knowledge on *muammalah*, they will have higher religiosity level which may improve good characteristics that are important for their business such as discipline, hard work and human relationship management.

خلاصة البحث

تهدف هذه الدراسة الي تقييم ودراسة أثر التمويل الاسلامي الصغير على الدخل ووضع الفقر مع الاشارة الى الوضع الديني والروحاني للعملاء. لتحقيق هذه الأهداف، فإن هذه الدراسة شملت معلومات عن حوالي اربعمائة عميل (400) من أصحاب المشاريع الصغيرة، ومن جملة هذا العدد بلغ عدد عملاء مؤسسات التمويل الاسلامي حوالي (360) عميل (تحصلوا على تمويل من خلال مؤسسات التمويل الإسلامي) في جاكرتا، اندونيسيا. غالبية هؤلاء العملاء هم أصحاب المشاريع الصغيرة والذين تقاسموا خصائص مماثلة مع بقية العملاء الذين يمثلون مجموعة للحكم و لمقارنة الآثار. لإثبات الفرضيات تستخدم هذه الدراسة الانحدارات المتعددة والسوقية. واجمالاً، وجدت هذه الدراسة ، كما تبين من فترة وجود التمويل الإسلامي الصغير ، وحجم هذا التمويل، ان التمويل الاسلامي الصغير قادر على توليد آثار إيجابية على دخل العملاء و على حالة الفقر. و ذلك على الرغم من انه لا يمكن الحصول على هذا التأثير الايجابي في المدى القصير، وتكون النتائج منطقية إذا تم قياس حالة الفقر من خلال استخدام معايير الفقر على الصعيد المحلي، ومعدل حد الفقر في دولة ما يجب ان يصدر عن جهة حكومية رسمية. نجد ان الأثر هو صغير نسبياً إذا تم قياس حالة الفقر من خلال استخدام معايير الفقر الدولي مثل معايير الفقر المدقع اوالمعتدل، أو تحقيق عائد يومي يبلغ واحد دولار أمريكي او اثنان دولار أمريكي للفرد الواحد في اليوم على النحو الذي اعتمده البنك الدولي والمنظمات الدولية الأخرى. وجدت هذه الدراسة أيضاً أن تكلفة التمويل لا تشكل أي تأثير كبير على دخل العملاء وحالة الفقر. وعلاوة على ذلك، فان توفر الظروف الاقتصادية الجيدة هو السبب الذي يجعل العملاء الذين يحصلون على التمويل من خلال المضاربة و المشاركة يعيشون حياة أفضل مقارنة مع أولئك الذين يحصلون على التمويل من خلال صيغة المرابحة. توصلت الدراسة الى نتيجة أخرى هامة و هي ان العملاء الاكثر تديناً بشكل عام يميلون لان يكونوا أكثر ثراء من أولئك الذين لديهم مستوى تدين أقل. كما توصلت هذه الدراسة أيضاً الى ان مستوى التدين له تأثير كبير على دخل العملاء وحالة الفقر. وتشير هذه النتائج الى ان مستوي التدين و الروحانية لدي العملاء يمكن استخدامها من قبل مؤسسات التمويل الأصغر الإسلامي في بناء القدرات للخدمات التي تقدمها لعملائها. لهذا الغرض، يمكن لمؤسسات التمويل الإسلامي تعزيز وتطوير معرفة العملاء بتعاليم الدين الإسلامي، لا سيما من حيث العقيدة،والعبادة ، والأخلاق ، والمعاملات وان تشرح لهم لماذا هذه الأمور مهمة ليس فقط لمرحلة ما بعد الموت والاخرة ، ولكن أيضاً للأغراض الدنيوية، بما في ذلك اثرها في تحسين أداء أعمالهم. فبالاضافة الى العقيدة القوية و السليمة، فان العملاء سيكون لديهم مستوى أعلى من القيم الروحية التي قد تعزز شغفهم وصبرهم. وبالإضافة الي ذلك، مع العبادة السليمة، والأخلاق الحميدة والمعارف المتعلقة بفقہ المعاملات ، سيكون لديهم مستوى تدين عالي الشئ الذي قد يحسن وجود من شخصياتهم الامر الذي يعتبر عنصر اساسي لاداء الاعمال وينعكس ذلك على الانضباط والاجتهاد في العمل وادارة العلاقات الانسانية والبشرية.

APPROVAL PAGE

The thesis of Ronald Rulindo has been approved by the following:

.....
Ataul Huq Pramanik
Supervisor

.....
Ahamed Kameel Mydin Meera
Internal Examiner

.....
Dato' Chamhuri Siwar
External Examiner

.....
Ismail Hassanein Ahmed Mohamed
Chairperson

DECLARATION

I hereby declare that this dissertation 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.

Ronald Rulindo

Signature

Date.....

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

**DECLARATION OF COPYRIGHT AND AFFIRMATION
OF FAIR USE OF UNPUBLISHED RESEARCH**

Copyright © 2012 by Ronald Rulindo. All rights reserved.

**ASSESSING THE IMPACT OF ISLAMIC MICROFINANCING ON
CLIENTS' INCOME AND POVERTY STATUS WITH REFERENCE TO
CLIENTS' SPIRITUALITY AND RELIGIOSITY IN JAKARTA, INDONESIA**

No part of this unpublished research may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise without prior written permission of the copyright holder except as provided below.

1. Any material contained in or derived from this unpublished research may only be used by others in their writing with due acknowledgement.
2. IIUM or its library will have the right to make and transmit copies (print or electronic) for institutional and academic purposes.
3. The IIUM library will have the right to make, store in a retrieval system and supply copies of this unpublished research if requested by other universities and research libraries.

Affirmed by Ronald Rulindo

.....

Signature

.....

Date

For Better Development of Islamic Banking and Finance

ACKNOWLEDGEMENTS

Alhamdulillahirabbil' alamin, I had completed and fulfilled requirement for the degree of Doctor of Philosophy in Islamic Banking and Finance. First and foremost, I would like to express my deepest gratitude to Allah, the most merciful and benevolence for His blessing, so that, I could accomplish this journey. I pronounce *shalawat* and *salaam* to Prophet Muhammad p.b.u.h. who enlightened us with Islam and taught us to continuously contribute to development of Muslim community; the reason that initiated me to undertake this degree.

I would like to extend my utmost appreciation to Prof. Dr. Ataul Huq Pramanik; my valued supervisor who guided me throughout the whole process of completing this degree. I should acknowledge sincere guide from Assoc. Prof. Dr. Ashraf Wajdi Dusuki and Assoc. Prof. Dr. Ugi Suharto too. Both of them previously were my supervisors. The direction and assistance that they gave to me assisted me in producing a qualified research proposal; the most important stepping stone in finalising this degree.

I need to express my heartfelt gratefulness to my parents Zahrul Umar and Idzurnida Ismael who taught me the importance of education. They sacrificed their live, so that, my sister and I always enjoyed the best quality of learning since early periods of our life. I have to convey my gratitude to my sister Laura Rulida too. With her kindness and benevolence, she constantly supports me to achieve everything that I dreams, including this degree. Special thank is deserved to be given to my lovely wife Amy Mardhatillah. Thank you for your love, patient, and passion. Your understanding, sacrifices, and supports during the entire period of my study are really incalculable. I also oblige to say thank you to my brother in Islam and in nation: Ahmad Ompo Sarwo Surono. You opened the door for me to start this journey. Through you, Allah has changed my life, drastically.

I also wish to articulate my thankfulness to my parents in law: Salman Syam and Asmayetti; to my in laws: Dedi Rivaldi Tabrani, Amy Fontanella, and Muhamad Daniel Arifin; and to my aunty Azizah Amat Tamsir. A great recognition should also be given to all my relatives particularly those who participated in raise, educate, and motivate me since my childhood, such as: Aunty Eva, Isriyetti, Isriyenni, Ismailinda and Erlinda, as well as Aunty Masna, Ramna and Rosna. My deepest appreciation is given to my late uncle Iserizal Ismael (alm). I really wish you could see me when I get this degree. You taught me how a man should live his life and never surrender regardless the challenges that he faces. Therefore, to my cousins, Nana, Cici, Lala, Adit, Fani, Ivan and Tio, please keep work and study hard to show that success is always in our blood.

A sincere gratitude should be given to all my best friends and colleagues: Sutan Emir Hidayat, Tika Arundina, Hidayatul Ihsan, Weni Hawariyuni, Muhammad Abduh, Raditya Sukmana, and Irfan Syauqi Beik. They accompanied me in accomplishing this degree. Sharing knowledge and experiences with them are among

the key to how I can successfully passed this process. Similar appreciation needs to be addressed to Hartomi Maulana, Todi Kurniawan, Muhammad Kholid, Fauzia Agustina Maarif, Angga Pradesha, Helmi and Al Fatih; those who studied with me during my post graduate degree, as well as to my informal teachers in my master degree, such as Nyimas Rohmah, Imam Bintoro, Erwin Hutapea, Aishah @ Ma Chi and Zhareer Hasan. A huge motivation to continue my study to doctoral degree I got from Islamic Economic Forum for Indonesian Development (ISEFID). Therefore, appreciation and recognition have to be given to all ISEFID founders and members, such as Ade Wirman, Handy Risza, Dodik Siswantoro, Masyudi Muqarrabin, Rahmatina Kasri, Miranti Kartika Dewi, Halida and Joel Farouk Sofyan. More gratitude is given to Ilham Reza Ferdian and Wisnu Wardhana, who really help me to collect data for my study. To my colleagues in Islamic Financial Services Board (IFSB): Abozer, Faris, Tina, Aziza, Mizuan, Shin Kim, Ali, Jamshaid, Zaheed, Ziki, and Dr. Abdussalam, thank you for all of your supports. May Allah always bless all of you. To my superiors, Prof. Dr. Rifaat Ahmad Abdel Karim, Jaseem Ahmed, Abdullah Haron, Abdelilah Belatik, and Noor Erni Surya Nordin, thank you for the opportunity to work with the IFSB while finalising this degree. To Dr. Ari Ginandjar Agustian of ESQ Leadership Center, thank you for motivation to study spirituality from Islamic perspective, in relation to economic activities.

Finally, I would like to express my love and gratefulness to my little princess Alia Athaya Rulindova. She played crucial role in assisting me to achieve the doctoral degree. She always makes me laugh and cheers me up when I was down, provides me with energy to work more and more. I hope someday she will exceed what I got, like I want to exceed what my parents got. I wish she could contribute a lot to Islam and to her nation in the future, Amin.

TABLE OF CONTENTS

Abstract	ii
Abstract in Arabic	iii
Approval Page.....	iv
Declaration	v
Copyright Page.....	vi
Dedication	vii
Acknowledgement	viii
List of Abbreviations	xvi
List of Tables	xviii
List of Figure.....	xxi
CHAPTER 1: INTRODUCTION.....	1
1.1. Background of the Study	1
1.2. Statement of the Problem.....	4
1.3. Research Objectives	5
1.4. Research Questions	6
1.5. Significance of the Research.....	7
1.6. Organization of the Study	9
CHAPTER 2: OVERVIEW OF MICROFINANCE DEVELOPMENT: ISLAMIC MODELS AND INDONESIAN EXPERIENCES	10
2.1. Introduction	10
2.2. Overview of Microfinance Institution.....	10
2.3. Issues in Operation of Islamic Microfinance Institution.....	14
2.3.1. Lack of Capital Vs. Over Liquidity	14
2.3.2. Higher Operational Cost and Interest Rate	15
2.3.3. Higher Risk and Unsound Credit Management	16
2.3.4. Weak Governance and Internal Control.....	19
2.3.5. Limited Managerial Capacity, Innovation and Capacity Building	20
2.3.6. Lack of Regulations and Supervisions.....	21
2.3.7. Limited Outreach, Impact and Sustainability	22
2.4. Overview of Islamic Microfinance	26
2.5. Issues in Islamic Microfinance.....	35
2.5.1. Question of Authenticity	36
2.5.2. Limited Numbers of Mudharabah and Musharakah financing ...	37
2.5.3. <i>Shari'ah</i> Compliant.....	40
2.5.4. Other Operational Issues	41
2.6. Development of Microfinance Industry in Indonesia	42
2.7. Development of Islamic Microfinance Institution in Indonesia	50
2.9. Concluding Remark	57

CHAPTER 3: LITERATURE REVIEW	59
3.1. Introduction	59
3.2. 1. Impact Assessment of Microfinance	59
3.2.1.1 Theory of Impact Assessment	59
3.2.1.2 Method of Impact Assessment	61
3.2.1.3 Data for Impact Assessment	66
3.2.2. Empirical Studies in Microfinance Impact Assessment	72
3.2.2.1 Bangladesh	72
3.2.2.2. Indonesia	72
3.2.2.3. Malaysia	74
3.2.2.4. Pakistan	74
3.2.2.5. South Africa	75
3.2.2.6. Rest of Asia (Thailand, the Philippines and India)	76
3.2.2.7. The rest of Africa	76
3.2.2.8. The rest of the World	77
3.3. Review on Spirituality and Religiosity	77
3.3.1. Definition of Spirituality and Religiosity	78
3.3.1.1. Definition of Spirituality	78
3.3.1.2. Definition of Religiosity	80
3.3.1.3. Spirituality and Religiosity Interrelationship	81
3.3.2. Islamic Perspective on Spirituality and Religiosity	83
3.3.3. Impacts of Spirituality and Religiosity	89
3.3.3.1. Impacts of Spirituality	89
3.3.3.2. Impacts of Religiosity	93
3.3.4. Spirituality, Religiosity and Entrepreneurship	96
3.3.5. Measurement of Spirituality and Religiosity	100
3.4. Concluding remark	105
CHAPTER 4: METHODOLOGY	107
4.1. Introduction	107
4.2 Model Selection and Hypotheses	107
4.3. Variable Selection and Data Description	110
4.3.1. Data Description for Dependent Variables	110
4.3.2. Data Description for Independent Variables	112
4.4. Conceptual Framework	119
4.5. Source of the Data	119
4.5. Data Collection	120
4.5.1. Definition of Population and Sample	122
4.5.2. Type and Procedure of Sampling	122
4.6. Estimation Techniques	123
4.6.1. Multiple Regression	123
4.6.2. Logistic Regression	124
4.7. Concluding Remark	125
CHAPTER 5: RESULTS AND DISCUSSIONS	127
5.1. Introduction	127
5.2. Length of Having Islamic Microfinancing	127

5.3. Modes of Financings	138
5.4. Size of Financing.....	145
5.5. Cost of Financing	150
5.6. Spirituality Level.....	154
5.7. Religiosity Level	159
5.8. Gender	163
5.9. Education.....	168
5.10. Age	173
5.11. Marital Status	178
5.12. Number of Dependants	182
5.13. Business Experiences	186
5.14. Participation in Training	189
5.15. Locations of Domiciles	195
5.16. Concluding Remark	199
CHAPTER 6: CONCLUSION AND POLICY RECOMMENDATIONS	201
6.1. Introduction.....	201
6.2. Summary of Major Findings.....	201
6.3. Limitation of the Study	204
6.4. Policy Recommendations.....	205
6.4.1. Policy Recommendations to BMTs	205
6.4.2. Policy Recommendations to Government and NGOs	209
6.4. Suggestion for Future Studies	212
BIBLIOGRAPHY	215
APPENDIX A	229
APPENDIX B	245
APPENDIX C	250
APPENDIX D	255

LIST OF TABLES

<u>Table No.</u>		<u>Page No.</u>
2.1	Data of Islamic Microfinance Institutions by Model	30
2.2	Comparison of Islamic MFIs and Conventional MFIs	32
2.3	Records on Microfinance Institutions in Indonesia for the Year 2004	47
2.4	Financial Comparison between BPRS and BPR	53
2.5	Financial Indicators of BPRS and BPR	55
3.1	Impact Assessment Tools	65
3.2	Comparison of Data Sources in Impact Assessment Studies	70
3.3	The Spirituality Scale Instruments	101
3.4	The Religiosity Scale Instruments	104
5.1	Magnitude of Clients' Income Based on Length of Having Islamic Microfinancing	129
5.2	Magnitude of Clients' Poverty Status Based on Length of Having Islamic Microfinancing	131
5.3	Summary of Regressions for Length of Having Islamic Microfinancing	132
5.4	Magnitude of Clients' Income Based on Modes of Financing	139
5.5	Magnitude of Clients' Poverty Status Based on Modes of Financing	140
5.6.	Summary of Regressions for Modes of Financing	142
5.7	Magnitude of Clients' Income Based on Size of Financing	146
5.8	Magnitude of Clients' Poverty Status Based on Size of Financing	147
5.9	Summary of Regressions for Size of Financing	148

5.10	Magnitude of Clients' Income Based on Cost of Financing	152
5.11	Magnitude of Clients' Poverty Status Based on Cost of Financing	153
5.12	Summary of Regressions Based on Cost of Financing	154
5.13	Magnitude of Respondents' Income Based on Spirituality Level	156
5.14	Magnitude of Respondents' Poverty Status Based on Spirituality Level	156
5.15	Summary of Regressions for Spirituality Level	158
5.16	Magnitude of Respondents' Income Based on Religiosity Level	160
5.17	Magnitude of Respondents' Poverty Status Based on Religiosity Level	161
5.18	Summary of Regressions for Religiosity Level	162
5.19	Magnitude of Respondents' Income Based on Gender	165
5.20	Magnitude of Respondents' Poverty Status Based on Gender	166
5.21	Summary of Regressions for Gender	167
5.22	Magnitude of Respondents' Income Based on Education	169
5.23	Magnitude of Respondents' Poverty Status Based on Education	170
5.24	Summary of Regressions for Education	173
5.25	Magnitude of Respondents' Income Based on Age	175
5.26	Magnitude of Respondents' Poverty Status Based on Age	176
5.27	Summary of Regressions for Age	177
5.28	Magnitude of Respondents' Income Based on Marital Status	179
5.29	Magnitude of Respondents' Poverty Status Based on Marital Status	180
5.30	Summary of Regressions Based on Marital Status	181
5.31	Magnitude of Respondents' Income Based on Number of Dependents	183

5.32	Magnitude of Respondents' Poverty Status Based on Number of Dependants	184
5.33	Summary of Regressions for Number of Dependants	185
5.34	Magnitude of Respondents' Income Based on Business Experience	187
5.35	Magnitude of Respondent's Poverty Status Based on Business Experience	188
5.36	Summary of Regressions for Business Experience	189
5.37	Magnitude of Respondents' Income Based on Participation in the Training	190
5.38	Magnitude of Respondents' Poverty Status Based on Participation in the Training	191
5.39	Summary of Regressions for Participation in the Training	192
5.40	Magnitude of Respondents' Income Based on Location of Domiciles	196
5.41	Magnitude of Respondents' Poverty Status Based on Location of Domiciles	197
5.42	Summary of Regressions for Location of Domiciles	198

LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Services Institution
ACCION	Americans for Community Co-operation in Other Nations
BKD	Badan Kredit Desa, or Village Credit Institution
BMI	Bank Muamalat Indonesia
BMT	Baitul Maal wat Tamwil
BNI	Bank National Indonesia
BPR	Bank Perkreditan Rakyat, or Rural Bank
BPRS	Bank Perkreditan Rakyat Syariah, or Islamic Rural Bank
BRAC	Bangladesh Rural Advancement Committee
BRI	Bank Rakyat Indonesia
CGAP	Consultative Group to Assist the Poor
CU	Credit Union
FINCA	Foundation for International Community Assistance
GTZ	German Technical Cooperation
HIRS96	Hatta Islamic Religiosity Scale
ICMC	International Catholic Migration Commission
ICMI	Ikatan Cendekiawan Muslim Indonesia, or Indonesian Muslim Scholar Association
IDB	Islamic Development Bank
IFSB	Islamic Financial Services Board
ITB	Institute Technology Bandung
KfW	German Financial Cooperation
LDKP	Lembaga Dana Kredit Pedesaan, or Rural Credit Fund Institution
MFI	Microfinance Institution
MRPI	Muslim Religiosity Personality Inventory
MUI	Majlis Ulama Indonesia
NGO	Non Government Organization
OLS	Ordinary Least Square
P2KP	Proyek Penanggulangan Kemiskinan di Perkotaan: Poverty Alleviation Project in Urban Areas, or Urban Poverty Alleviation Project
PHBK	Proyek Hubungan Bank dengan Kelompok Swadaya Masyarakat: Project, or Linking Banks and Self-help Groups Project
PINBUK	Pusat Inkubasi Bisnis dan Usaha Kecil, or Center for Small Enterprise Development
PKK	Program Pengembangan Kecamatan, or Sub-district Development Project
PKM	Program Keuangan Mikro, or Microcredit Program
PRADAN	Professional Assistance for Development Action
RIGP/P4K	Rural Income Generation Project
RoI	Religiosity of Islam Scale

SHG	Self-Help Group
SSB	<i>Shari'ah</i> Supervisory Board
SSE	Small Scale enterprises
SWB	Spiritual Well-Being Scale
UED-SP	Unit Ekonomi Desa Simpan Pinjam, or Village Saving-Credit Unit
UK	United Kingdom
UPPKS	Usaha Peningkatan Pendapatan Keluarga Sejahtera, or Family Welfare Income Generation Project
VIF	Variance Inflation Factor
WB	The World Bank

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Poverty is an unresolved problem for most developing countries. According to the World Bank (2007), there were 880 million people living under extreme poverty level or with less than US\$1 a day. Moreover, 2.1 billion people were living under moderate poverty level or with less than US\$2 a day at the same time.

Over the past two decades, policy makers, international development agencies and non-governmental organizations (NGO) have taken up various efforts aimed at reducing poverty in developing countries. A prominent effort in this regard is microfinance (Afrane, 2002). Microfinance refers to the provision of financial services to poor or low income clients, including consumers and the self-employed (Ledgerwood, 2001). Basically, microfinance works by providing financial schemes or financial services in the form of savings and credit opportunities to the working poor.

The reason for the microfinance approach is that the lack of access to productive capital has been found to have caused poverty in less industrialized countries. With limited productive capital, poor people are only able to produce at a subsistence level. This makes it difficult to accumulate savings or assets, or to invest in productive resources or gain access to credit in formal capital markets. This situation apparently leads to low productivity and continued poverty (Coleman, 1999).

Consultative Group to Assist the Poor (CGAP), an international institution concerned with the development of microfinance institutions in the world, regards

microfinance as a powerful tool in alleviating poverty (CGAP, 2004). Providing access to financial services such as savings, credit, transfers, payments, and insurance can help the poor to take control of their financial situation. In addition, microfinance empowers women specifically to make critical choices about investing in businesses, sending their children to school, improving the healthcare of their families, covering the cost of key social obligations such as marriages, and protecting themselves from crises (CGAP, 2004). Kulik and Molinari (2004) also note that microfinance is unique in development models. This is because the programme approaches financial sustainability, which enables them to reach far beyond the limits of scarce donor and charitable resources. Therefore, microfinance institutions (MFIs) are able to deliver social benefits to their clients on a regular basis and at a larger scale.

The increasing prominence enjoyed by MFIs as a poverty alleviation tool necessitates an assessment of its efficacy (Mosley, 2001). Being a relatively new development tool in poverty alleviation, a critical research is needed to understand how medium to long-term changes in the well-being of participants in the microfinance programme exist (Wydick, 2002). Stakeholders therefore, need to verify that the objective of microfinance - poverty alleviation is pursued vigorously. As a result, impact assessment studies are also carried out to provide MFIs with organizational learning and to ensure that their mission and objectives of working with the poor in their struggle against hunger, disease, exploitation and poverty are being achieved (Johnson & Rogaly, 1997).

Proving the impact of MFIs should not be restricted to conventional MFIs only. It should also be extended to the Islamic-version of MFIs (Islamic MFIs). The success of MFIs in alleviating poverty has supported the development of faith-based microfinance institutions including Islamic MFIs. This mode of MFIs provides

interest-free financial services that are compliant with the *Shariah* or Islamic law. These institutions also integrate Islamic social charitable funds such as *zakat*, and *waqf* as their sources of fund. This enables the Islamic MFIs to distribute funds to the poor community (Obaidullah, 2008; Ahmed, 2002).

Based on the distinctive characteristics of the Islamic MFIs, Ahmed (2002) argues that Islamic MFIs can perform better compared to the conventional ones. He argues that the Islamic teachings provided to the Islamic microfinance institutions improve solidarity and social capital among the clients. This allows them to be better debtors since repayment is considered as a religious obligation. In addition, the social capital derived from Islamic values and principles positively influences the employees of Islamic MFIs, as it provides them the additional incentive to strive for the betterment of the lives of the poor. As a result, the improvement in the profitability and viability of Islamic MFIs are ensured. That is, Islamic social capital increases the productivity of employees (thus reducing costs), and at the same time, it reduces the default rate of the clients (Ahmed, 2002).

To date, there have been only a few impact assessment studies conducted on Islamic MFIs. Therefore, there is a need to fill this research gap on assessing the impact of Islamic MFIs on their clients. In addition, there are also inconsistent findings on impact assessment studies on conventional MFIs. In the case of conventional MFIs, Hulme (2000) classifies the results of microfinance impact assessment into three categories. The first category supports the opinion that microfinance has very beneficial economic and social impacts; while the second promotes caution against optimism on microfinance. Researchers who support the opinions related to the second category address the issue on the negative impacts that microfinance can have. The third category lies between these two arguments. In this

case, researchers recognize microfinance as having beneficial impacts but do not assist the poorest, as often claimed.

In relation to Islamic MFIs, most of the impact assessment studies claim that the Islamic microfinance has favourable impact on their clients. However, similar to early impact assessment studies on conventional MFIs, the impact assessment studies on Islamic MFIs only provide anecdotal evidences which are collected without proper impact assessment methods. Only few studies utilize proper methods in assessing the impact of Islamic microfinance such as Widyanto and Abdul Ghaffar Ismail (2006) who made a significant study. Nevertheless, their study found more significant influence of individual and socio-economic characteristics on improvement of clients' business rather than the impact of having access to Islamic microfinancing. Therefore, assessing the impact of Islamic microfinance on their clients still remains an important area on which research should be conducted.

1.2 STATEMENT OF THE PROBLEM

Lack of rigour literatures that assess impact of Islamic MFIs is the main reason why this study is undertaken. For this purpose, this present study assesses the impact of Islamic microfinance on micro entrepreneurs who are their clients. The impact will be benchmarked into poverty alleviation since the main objective of most MFIs is to help the poor uplift themselves out of poverty. In this study, poverty alleviation is further divided into two separate indicators; namely income and poverty status. The main reason behind this subdivision is the view that increasing the income of the poor is the first step toward improving their wealth (Zaman, 2000). However, increasing the income of the poor does not necessarily improve their poverty status (Wright, 1999).

This is because there is the possibility that an increment in income is necessary but not adequate to bring the micro entrepreneurs out of poverty.

Most of the impact assessment studies assess the affect of demographic and socio economic variables such as age, gender, marital status, educational background, and business experience on the impact indicators. This is because, there is possibility that these attribute is the reason behind the improvement and not the microfinancing per se. However, none of impact assessment studies consider the possible influence of clients' spirituality and religiosity on the improvement of impact indicators. In contrast, there is an argument that spiritual commitment combined with practical support can be more effective in improving the lives of the poor than mere technical help can do (Tripp, 1999). Similarly, Muslim scholars suggest that Islamic microfinance institutions should include a spiritual development programme in providing capacity-building for their clients (Ahmed, 2002). A number of Islamic MFIs have provided such services at various degrees. Unfortunately, to the best of the researcher's knowledge, there have been no studies that suggest spiritual and religious development programmes may contribute to the improvement of clients' well-being. Due to this circumstance, this study make a reference on the possible influence of clients' spirituality and religiosity in assessing the impact of Islamic microfinancing on clients' income and poverty status.

1.3 RESEARCH OBJECTIVES

In line with the statement of the problem, this study attempts to achieve the following objectives:

1. To investigate the impact of microfinance service of Islamic microfinance institutions on clients' income and poverty status.

2. To explore the effect of clients' spirituality and religiosity on the changes in their income and their poverty status.

1.4 RESEARCH QUESTIONS

Several variables are utilized in assessing the impact of Islamic microfinance on the income and poverty status of the Islamic MFIs' clients. Length of having Islamic microfinancing and size of financing are the common examples. As this study focuses on Islamic MFIs, it also aims to prove whether there are different impacts experienced by the clients who receive different modes of financing. Specific attention is given to clients who receive *Mudharabah* or *Musharakah* financing. These modes of financing are profit sharing in nature and most Islamic economists believe that they bring more social economic justice to the recipients. Therefore, comparing the impact of these modes of financing with other modes, especially with *Murabahah* financing, which dominates the mode of financing in recent Islamic financial services industry, would be very interesting.

Many previous studies criticized the practice of microfinance for charging higher interest rate on the recipients. The similar criticism is also directed to Islamic MFIs. This study, therefore, also involves the cost of financing in analyzing the impact of Islamic microfinancing on clients' income and poverty status.

Based on the information above, to achieve the first objective of this study which is to assess impact of Islamic MFIs on clients' income and poverty status, a set of research questions is developed for this purpose. The questions are as follow:

1. Does the length of time having access to Islamic microfinancing affect clients' income and poverty status?

2. Does a mode of financing have an influence on the clients' income and poverty status?
3. Does the size of financing contribute to clients' income and poverty status?
4. Does the cost of financing affect clients' income and poverty status?

As the second objective of this study is to assess the possible influence of clients' spirituality and religiosity on their income and poverty status, there are two additional research questions are developed:

1. Does the clients' spirituality level have an influence on their income and poverty status?
2. Does the clients' religiosity contribute to their income and poverty status?

1.5 SIGNIFICANCE OF THE RESEARCH

This study is significant for three major reasons. First, it provides deep analysis on the impact of microfinancing through comparison of techniques and measurement of impact indicators. This initiative is important to be undertaken considering inconsistency in the finding of previous impact assessment studies. Previous studies rarely compared different techniques and benchmarks for each impact indicators. In this study, two alternatives of longitudinal design: retrospective techniques and control group are compared in assessing impact of Islamic microfinancing on clients' income. Subsequently, the results are compared to impact of Islamic microfinancing on clients' poverty status. The objective of this comparison is to investigate to what extent the opinion that improving clients' income is not necessarily improving clients' poverty status is applicable in Islamic MFIs. In terms of poverty status per se, the impact will be compared subjectively by asking the clients personal opinion on their