



**COMPARATIVE STUDY OF ISLAMIC FINANCIAL
INSTITUTION OFFERING MICRO TRADER CREDIT IN
MEDAN INDONESIA**

BY

SAFWAN BUKHARI

**A research paper submitted in fulfilment of the requirement
for the degree of Master of Science (Islamic Banking and
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International Islamic University Malaysia**

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ABSTRACT

This research study the effectiveness of micro credit that offered by Islamic financial institution to micro traders in Medan Indonesia. It also analyse the perception of the micro traders on the Islamic microfinance that are offered by Islamic financial institutions. In addition, the service, procedure, and the requirement on Islamic financial institutions on offering credit to micro traders are examined. This analysis is expected to assist micro traders in expanding their business. Furthermore, the researcher also approached several micro traders to gain their perspectives on Islamic microfinance, and identify alternative funding that they can use to increase the capital. In addition, the government program is still popular among the traders in gaining credit due to low interest as compared to Islamic microfinance. There are two instruments that were developed to collect the data; the first instrument was interviewing the practitioners in Islamic financial institutions, to obtain the accurate data of Islamic microfinance product. The second instrument was by approaching the micro traders in Medan to collect information regarding the micro credit. Among the findings, financial illiteracy is considered the main issue for the traders, due to this problem many of the traders will choose other sources of funding as an alternative for gaining more capital. Based on the result, Rural Credit Business (KUR) is still popular among the traders followed by the alternative source funding. This observation indicates that Islamic microfinance product still needs to be promoted among the traders.

خلاصة البحث

يهدف هذا البحث إلى دراسة مدى فعالية القروض الصغيرة التي تقدمها المؤسسات المالية الإسلامية إلى أصحاب المشاريع الصغرى في ميدان إندونيسيا. كما يدرس البحث انطباق اصحاب المشاريع الصغرى عن برنامج التمويل الأصغر الإسلامي الذي تقدمه المؤسسات المالية الإسلامية. وبالتالي، يلقي الباحث الضوء على خدمات واجراءات ومتطلبات المؤسسات الإسلامية لتقديم القروض لاصحاب المشاريع الصغرى. ومن المتوقع أن يساعد هذا التحليل أصحاب المشاريع الصغرى في توسيع أعمالهم. وإضافةً إلى ذلك، توجه الباحث إلى العديد من أصحاب المشاريع الصغرى للحصول على وجهة نظرهم بشأن التمويل الأصغر الإسلامي، وتحديد التمويل البديل الذي يمكنهم استخدامه لزيادة رؤوس أموالهم. وبالإضافة إلى ذلك، لا يزال البرنامج الحكومي شائعا بين التجار في الحصول على القروض بسبب الفائدة المنخفضة مقارنة مع التمويل الإسلامي الأصغر. وتم استخدام وسيلتين لجمع البيانات؛ والوسيلة الأولى هي عبارة عن إجراء مقابلات شخصية مع الممارسين في مجال المؤسسات المالية الإسلامية للحصول على بيانات دقيقة عن التمويل الأصغر الإسلامي كمنتج. كما وتم الذهاب الى التجار الأصغر في ميدان لجمع المعلومات المتعلقة بالقروض الصغيرة. ومن بين النتائج التي تم التوصل إليها، تعتبر الامية المالية القضية الرئيسية للتجار، وبسبب هذه المشكلة سيختار الكثير من التجار مصادر تمويل أخرى كبديل لكسب المزيد من رأس المال. واستنادا إلى ما تشير اليه الملاحظة، لا تزال الأعمال الائتمانية الريفية (KUR) الأكثر شعبية بين التجار يليها المصادر التمويلية البديلة. وتشير هذه الملاحظة إلى أن منتج التمويل الأصغر الإسلامي لا يزال بحاجة إلى تعزيز بين التجار.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Science (Islamic Banking and finance).

.....
Syed Musa Alhabshi
Supervisor

This research paper was submitted to the IIUM Institute of Islamic Banking and Finance and is accepted as a fulfilment of the requirement for the degree of Master of Science (Islamic Banking and Finance).

.....
Rusni Hassan
Deputy Dean, IIUM Institute of
Islamic Banking and Finance

DECLARATION

I hereby declare that this research paper 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.

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CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

The development of economy can be interpreted as a process activity which is implemented by a nation to improve the income and welfare continuously in a long-term period. The Indonesian society welfare is yet to be categorized as high because, the economic situation of Indonesia is still in the growth stage which affects the welfare of the Indonesian people. Thus, feasible income is needed in order to get to fulfill the needs of the people, as many of them attempt to become micro traders to enhance their incomes such as, traders, farmers etc. In conducting those kinds of businesses, many of them have problem with capital to support their businesses whereby relying on banks or other financial institutions to support them by giving credits. The bank's role as a financial entity that improves the economy in particular and the living standards of the people in general stems from a point where it provides platforms to deposits, savings, loans, and other financial activities. In terms of remuneration or consideration for the use of funds, for both savings and loans, according to Bank Indonesia Regulation No. 9/7 / PBI / 2007 quoted (Totok Budisantoso and Sigit Triandaru, (2006) the bank is divided into two, namely:

- a.** Conventional bank: it is the bank where activities whether is accumulation funds or mobilization of funds, a given percentage in the form of interest for using funds over a certain period is anticipated.
- b.** Islamic (Shari'ah) Bank: it is the banks where the activities are based on Shar'iah principles which entail profit and loss sharing between the parties

According to Muhammad (2005), the basic things that distinguishes conventional and shari'ah banks is the return, and distribution of profit that is given by customers to the financial institution or vice versa. The legal basis for the operational aspect of Islamic banking is based on the Law No. 77, 1992 on banking, where the regulation the principle of sharia as sharing profit is still disguise. Furthermore, the Law No.77, 1992 has been upgraded to Law No. 10, 1998 which organizes more on specific legal basis and the variety of venture that can be operated and decided by Islamic banking which shows the sign of Islamic banking in the reformation era. Subsequently, both regulations refined with new Law No. 21 2008 on Islamic banking, where the regulation regulates the activity and the process of Islamic banking and Shari'ah business units in implementing their business activities.

The global financial crisis had brought an impact to the development of Islamic bank. The prospect of Islamic bank in the world has become bright and promising, and the system has better foundation and develop continuously ever since. This industry is expected to strengthen the stability of the national financial system. Bank Muammalat Indonesia, as the first Islamic bank in Indonesia, derived the sources of the concept from the holy Qur'an and Hadist of the Prophet Muhammad (peace be upon him) and the *ijtihad* of scholars. The purpose is to uphold the justice and the social welfare as commanded by Allah SWT. An act of worship is a pure relation between Allah SWT and human being as his servant, while *mu'ammalah* (daily activity) is a horizontal link between human and social economic such as, trading, renting, financing and other things. The relation in mu'ammalah is tailored with Shari'ah as Allah said in the Qur'an,(Ali Imran, verse 130)

O you who have believed, do not consume usury, doubled and multiplied, but fear Allah that you may be successful.

In doing economic activities such as investment or trading, the Muslims are encouraged to avoid *riba* (usury/interest). Investment in Islamic bank means as an obligation to party who has excess in wealth to distribute their wealth in a productive activity and provide new employment opportunities, and facilitate the flow of goods and services. This philosophy embedded by Shari'ah is believed by the scholars and Islamic thinkers to give an encouragement solidarity and cooperation in achieving prosperity.

Since the enactment of Law No. 21 2008, the legal basis Islamic banks has been fairly good in terms of institutions and fundamental operations. It also helps the development of Islamic finance knowledge to create innovations and better systems that govern life in all aspects. With the development of science, it can be an encouragement for a change in the economic system of society. Islamic economy that has been growing in Indonesia also applied to the financial institutions or in non-bank financial institutions. Baitul Maal Wat Tamwil (BMT) is one of category of non-bank financial institutions that are informal, because the existence of BMT does not require formal legitimacy of government/ relevant agencies. The performance of BMT is almost equal to a cooperative scheme in which there is also a variety of products for fundraisers and the distribution of funds. And it is a business activity is similar to Islamic banks, applying the profit sharing.

BMT (Baitul Maal Wat Tamwil) is a non-government organization, which is founded and developed by society. BMT is established with capital from the community to the people who lived therein. The establishment of BMT not only got

supports from the community, but also from outside fund-raising sources such as, receiving zakah, sadaqah, and waqf.

BMT was originally established as a popular economic institutions to help people in need, the poor. The main activity of BMT is to develop micro and small enterprises, especially regarding capital aid. In order to accelerate a financing, the BMT seeks to collect as many funds sourced from the local communities and outside sources of fund-raising. As an Islamic financial institutions, BMT should stand on the principles of Sharia.

BMT which aims at developing the productivity of micro and small bussines and investing to improve the quality of the activities of micro and small business, it provides convenience services semi banking, especially for traders that are economically weak. This would eventually enable it to explore the potentials and increase the productivity, and increase the income and economic development in Indonesia, especially in Medan.

Businesses and economic growth in Indonesia comprise of four categories, the micro, small, medium, and large business. According to the data from the Ministry of Cooperation and Small Medium Enterprises as of 2014, the number of traders involved in micro business in Indonesia in 2013 were as much as 52.176.795 or 98.88% of the markets. Small business is about 546.675 or 1.04% of the market, while the medium and large businesses were about 41.133 or 0.08% and 4.677 or 0.01% of the market respectively. Therefore, the business that dominated in Indonesia as the locomotive of national economy is the micro business. The laborers that are recruited by the micro business are the largest if compared to other three sectors; almost about 90.012.694 laborers. Despite this, there are several crucial problems for the growing of the sector which are capital or funds.

Basically, the main function of credit is to service the society to support the micro trader's activities such as, trading, production and other services, where the purpose of credit is to enhance the level of economic of the society. However, there are many of them facing the financial obstacle because the bank is not giving them credit without taking collaterals; where most of the micro traders cannot fulfill requirements as requested by bank. Therefore, on 5th November 2007, the Government of Indonesia has launched a program to help the micro traders, named Society Business Credit [Kredit Usaha Rakyat (KUR)]. The purpose of this program is to enhance their capital, which would help them to expand their businesses. The distribution of KUR is conducted by Government's banks such as Bank Rakyat Indonesia (BRI), Bank Mandiri, and Bank Negara Indonesia (BNI).

According to Latief Adam from the Economic Research Center Science Agencies Indonesia, there are two main problems in the distribution of KUR which are:

1. The interest is higher than conventional credit.
2. Credits are not targeted appropriately.

These problems will create another issue for the micro traders who are involved in the KUR programs. Meanwhile, as Islamic financial institution, the financial institution should implement the Shari'ah principle that prohibits of *riba* (usury/interest), and creates a mechanism that help the micro traders in financing their activities. In addition, the Islamic financial institution here is not merely tied up with banks; rather it can be non-bank financial institutions that offer microfinance to small traders.

Therefore, the researcher eager to do a research with the title **THE COMPARATIVE STUDY ON ISLAMIC FINANCIAL INSTITUTION OFFERING MICRO TRADERS CREDIT IN MEDAN INDONESIA**. I hope this research may be useful for many in the future.

1.2 PROBLEM STATEMENT

Micro business is a part of society's economy which cannot be ignored as it has very big potential for growth. Micro traders in the country have had a change such as better quality of live, besides that micro business is able to contribute employment creation in the society, and alleviate poverty. Despite of its great potential to growth, the micro traders are unable to maximize its potential because their lack capital, thus making the contribution of micro business to the economic development relatively small. Despite the existence of the KUR, the researcher has made a claim about this program, that the commission rate given by Islamic micro finance institution is higher than conventional bank which can cause problems for the micro traders in the future.

The Islamic microfinance offered by Islamic financial institutions is expected to be as an alternative that could help micro traders to gain credits to pump up their capitals, as these institutions clearly apply Sharia'ah concept in their financings such as sharing profit. However, in applying the Islamic concept, the Islamic financial institutions might face several problems such as promotional aspects of the products and the knowledge of the micro traders on the products. In other words, the effectiveness of the product for micro traders in financing them could be problematic.

1.3 PURPOSE OF STUDY

Micro trading is an alternative to alleviate poverty in the country and because of the existence of the micro trading reduces the level of unemployment in the country as well as it will increase people's income. However, there are several problems such as lack of capital, marketing of the products, and technological obstacle to produce the products, which would eventually have negative impact the performance of the micro trading itself. The purpose of this study is to analyze the comparison of the Islamic financial institutions that offer micro credit to micro traders in Medan, North Sumatera. Researcher also analyze the performance of micro trader's capital before and after receiving micro financing from those Islamic financial institutions, as well as the significant impact of micro credit on the micro trading. The research also emphasizes on other alternative sources of funding outside of micro finance institutions. Furthermore, researcher hopes this research will give benefit both on the academic as well as the practical side on the practices of Islamic financial institution in Indonesia as in general and in Medan as particular. Hopefully, this research might become a reference and it can be a comparison for any research that pertaining to the topic in the future.

For the practical side, this researcher believes that this research might be beneficial for the Government regarding the distribution and the financing of micro business through the Islamic micro finance model. Subsequently, this research is expected to increase the effectiveness and awareness of the officials and workers who are involved in Islamic micro finance practices. Finally, this research might also give information to the society about micro financing sector in Islamic micro finance.

1.4 RESEARCH OBJECTIVES

The most important purpose of this research is to find out the factors that will be influential and acceptable by customers (micro traders) of Islamic financial institutions regarding the financial schemes that are being provided by them. As such, the research objectives carry the followings:

1. To identify the services and products that are offered by the Islamic financial institutions in Medan Indonesia.
2. To analyze the alternative sources of funding that can be used by micro traders.
3. To increase the awareness among micro traders on Islamic microfinance models.
4. To identify the effective factors that micro traders prefer using for their Islamic microfinance or alternative sources of funding.

1.5 RESEARCH QUESTIONS

The research questions contain the followings:

1. What are the services and products that are being offered by Islamic financial institutions?
2. What are the alternative sources of funding that micro traders may use?
3. What is the level of awareness of Islamic microfinance institutions among micro traders?
4. How effective the Islamic microfinance or alternative sources of funding is utilized among micro traders in Medan?

1.6 LIMITATIONS OF THE STUDY

The scope of this research only covers the micro traders that are involved in Islamic micro finance scheme provided by Islamic financial institutions in Medan. The researcher will conduct interviews on several Islamic financial institutions to gain information regarding the Islamic micro finance scheme in Medan. In order to obtain the information regarding costumers' acceptance of the scheme, this research will be targeting costumers involved in Islamic financial institution through the purposive sampling. This will state all the factors based on Shari'ah perspective, financing system, and the services that influence the costumers' acceptance toward the Islamic financial institutions. The population target of this research is about (40) respondents which are the costumers that engaged in Islamic microfinance scheme.

CHAPTER TWO

LITERATURE REVIEW

2.1 INTRODUCTION

Medan is the capital city of the province of North Sumatera, where the population is approximately about 3 million people. From this population, approximately 224.000 have micro, small and medium businesses operating in Medan, whereby 17.000 are involving into micro traders such as, small vendor, sellers at the traditional market etc. From the research of Government office of Cooperation in Medan, the trend of micro traders in Medan is in increasing trend over the years. Qamarul Fatah as a Head of Government office of Cooperation encourages the creation of a creative industry, until the income of microtraders increased significantly. He also mentioned one of the effort that the government had done was creating mediation with the owner of capital, either is through the financial institutions or other institutions to support them in capital-related matters, because the main problem of the micro traders is lack of capital. According to him, once this problem is settled, it will have firm impacts on their productivities.

Furthermore, the leader of the communication forum of the micro small medium business Azri Smak has expressed that the growing public interest in opening new businesses is expected to drive up the economic growth and reduce the level of unemployment level of the city.

2.2 DEFINITION OF MICROFINANCE

Microfinance is a method of providing financial services to low-income household who lack access to comercial banks. It is considered as an effective tool to combat

poverty, especially in developing countries. Ledgerwood (1999) defines microfinance as the provision of financial services largely in the form of savings and credit, to low-income people. Other forms of services include insurance and social intermediation, and entrepreneurial trainings, such as in financial literacy and management. Brandsma and Burjorjee (2004), has characterized microfinance as:

1. Focus on poor entrepreneurs who lack access to commercial banks.
2. Simple and convenient access to small, short term, and repeat loans, with the use of substitute collateral and informal appraisal of investments and borrowers.
3. Provision of voluntary savings services that facilitate small deposits, with convenient collections and easy fund access.

According to Berger, Goldmark, and Sanabria (2006), a requisite of microfinance is knowledge of customers. Usually, MFI clients have informal and family-based operations. These micro enterprises, the owners and employees, lacked proper accounting and management knowledge; two factors that feature prominently in commercial banks' requirements.

Asian Development Bank (2000), and La Torre and Gianfranco (2006) had categorized microfinance into three types, in terms of governmental regulations:

1. Informal. Unregulated or uncontrolled by regional authorities. Institutions include self help groups, credit associations, families (relatives), and individual money lenders.
2. Semi-formal. Registered entities and subject to all financial institution regulations. Although they provide several financial services, institutions do not receive deposits or grant loans. Hence, they operate as financial

intermediaries, but are not regulated as commercial banks. Institutions include financial NGOs, financial cooperatives, and postal savings banks.

Formally. They can be divided into three groups: microfinance divisions of commercial banks, rural banks, and cooperatives. Institutions are regulated as commercial banks.

Microcredit is the main product of microfinance, although microfinance institution has numerous financial services. There are three main credit types provided by microfinance institutions. The first is consumption credit intended to finance the purchase of non-durable goods. The second type is productive credit (microcredit), which helps clients develop or start a new business, and generally with little collateral or none. And the third is corporate credit, the most common type provided to small and medium businesses, always with collateral.

2.3 CONVENTIONAL AND ISLAMIC MICROFINANCE

Microfinance institutions (MFIs) often start as non-profit enterprises with the social goal of helping the poorest to gain access to financial services (Pischke 2006 and Rouse). Their establishments are made possible by grants and donations from private donors and development agencies, and as they develop, maintaining their provision of services to poor clients becomes a main imperative. Independence from initial subsidies and through the ability to generate their own profits, it becomes essential to sustainability. Amongst conventional MFIs, this is achieved through the use of interest, while Islamic MFIs, prevented by Islamic law from using interest, implement profit-sharing schemes and accept public donations.

Grameen Bank, as a pioneer amongst microfinance institutions, has successfully provided financial services to the peoples of Bangladesh for nearly forty

years, much of them credit schemes through group lending. It also partakes in number of social programs, such as capacity building and programs empowering women and beggars. However, this institution is known to use interest-based schemes (Meisami, Manzur, and Roayae, 2011). Islamic MFIs have their own inherent characteristics that help mitigate the financial risks faced by conventional MFIs (Ahmed 2002). Some principle differences between conventional and Islamic microfinance. The differences between conventional and Islamic microfinance institution showed the table below;

Table 2.1: Comparison Conventional and Islamic Micro Finance

Item.	Conventional.	Islamic MFI.
Liabilities (source of fund)	External funds, clients saving.	External fund, client's saving, charity based sources.
Asset (mode of financing)	Interest based.	Islamic law based.
Financing the poorest.	Poorest are left out.	Poorest can be reached through integrating charity based funds with microfinance.
Fund transfer	Cash transferred.	Good transferred
Deduction at inception of contract.	Part of the funds deducted at inception.	No deduction at inception.
Target group.	Women.	Family.
Liability of the loan (for women customers)	Reciepent.	Reciepent and spouse.
Employee motivations.	Monetary.	Monetary and religious.
Dealing with default	Group/center pressure and threats.	Group/center/spouse/guarantee and Islamic ethics.
Social development program.	Secular (or non-Islamic) behaviour, ethical, and social development.	Religious (includes behaviour,ethics and social).

Source: Ahmed 2002.

Additionally, Islamic microfinance can utilize charity funds, such as *zakat*, *infaq*, and *shadaqah*, as their fund sources for delivering financing, whereas