



# Proposing an Integrated Islamic Microfinance Model in Alleviating Poverty and Improving the Performance of Microenterprises in Indonesia

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## Abstract

**Objective** – This study proposes an integrated Islamic microfinance model in alleviating poverty and improving the performance of microenterprises based on a case study of Indonesia, by focusing specifically on BRI Microbanking.

**Design/methodology** – This study adopts the exploratory study to construct the integrated Islamic microfinance with the purpose to alleviate poverty and enhance the business performance of enterprises.

**Results** – As Islamic microfinance is known widely due to the high demand from Muslim countries. Since, it plays a crucial role effectively in alleviating poverty and developing the business performance on enterprises, particularly on microenterprises. Presently, many scholars attempted to build a successful Islamic microfinance model by using Islamic financing instruments such as mudarabah, musyarakah, and murabahah. This study attempts to build an integrated Islamic microfinance model by using BRI Syariah Micro as a case study. It is expected that this integrated Islamic microfinance model can enrich existing models in terms of social and economic aspects.

**Originality/Value** – This research concentrates on proposing an integrated Islamic microfinance model based on the case study of BRI Syariah Microbanking. There seems to be a gap in the literature on the actual implementation of integrated Islamic microfinance in the world. The study highlights major factors to be emphasized to ensure the effectiveness of proposing an integrated Islamic microfinance model for BRI Syariah micro banking to alleviate poverty and to improve the performance of microenterprises.

**Keywords:** Islamic Microfinance, Integrated Islamic Microfinance Model, Enterprise, Microenterprises, BRI Syariah Microbanking.

## 1. Introduction

Countries from around the world are giving increasing attention to microfinance institutions (MFIs) in view of their important roles in generating employment and economic growth (Bhasin & Akpalu, 2001; Santos, 2003). MFIs in many countries such as Grameen Bank in Bangladesh, BancoSol in Bolivia, and Bank Rakyat Indonesia (BRI) in Indonesia have shown to be successful in alleviating poverty and improving microenterprise performance. Some of these studies include (Al-Mamun & Mazumder, 2012; Karlan & Zinman, 2009; Simeyo, Martin, Nyamao, Patrick, & Odondo, 2011). The growth of microenterprises plays a crucial role in encouraging economic development by producing employment (job opportunities) and increasing productivity (Hawariyuni, 2014).

Mosley (1997) for example, deliberated on how microfinance has helped to improve the income and employment of borrowers of the BancoSol lending program. In a related study where the Subsidy Dependence Index (SDI) was used, Mosley & Hulme (1998) showed how BancoSol has had a positive impact on income in Bolivia. In the case of Bangladesh, Khandker, R. Shahidur Samad & Khan (1998) demonstrated how

MFIs in the country, such as Grameen Bank, Bangladesh Rural Advancement Committee (BRAC) and Rural Development Project (RD 12) had positively affected income, production, and employment of the microfinance participants; while (Bhasin & Akpalu, 2001; Vogelgesang, 2001) showed that microfinance has helped improve technical efficiency, productivity, and growth of microenterprises in Cape Coast and Bolivia respectively.

As microfinance grows faster in the world including in countries with huge Muslim population such as Indonesia, Malaysia, and Bangladesh, there is a pressing need to explore the viability of offering Islamic microfinance. Goud (2006) argued that the microfinance based on the Islamic model provides a new image of social enterprise by replacing the interest-based micro-financing with that based on the profit-loss sharing model. The emergence of Islamic microfinance model causes many governments and non-government organizations such as Islamic Development Bank (IDB) and Consultative Group to Assist the Poor (CGAP) transferring knowledge related with Islamic microfinance as a new approach to alleviate poverty. It is suggested that at the beginning of the establishment of Islamic microfinance, mostly loan paid in terms of *qard hasan* (loans without fee), and every cost earned will be covered by *sadaqa* and using *zakat* as loan forgiveness for the people who do not have the ability for repayment. In terms of application, Islamic microfinance can offer similar instruments as the Islamic banks based on the *mudharabah*, *murabahah*, and *musyarakah* contracts.

Indonesia is one of the countries with a huge Muslim population with a variety of both conventional and Islamic microfinance (Ascarya, 2014; Seibel, 2007). In most cases, microfinance programs related to the Indonesian government program to combat poverty and reduce unemployment. Ascarya (2014) highlights that there are varieties models of microfinance in Indonesia started from the cooperative model, Grameen model, micro-unit of commercial bank model, and rural bank model. He further argues that even though Indonesia has varieties model of both conventional and Islamic microfinance, these MFIs are still unable to reach the demand of 55.9 million microenterprises (ME) in the country. There are still lots of microenterprises that could not access loans from both these conventional and Islamic MFIs. Indonesia Delegation for SMEs's Ministerial Meeting (2003) in APEC (Asia-Pacific Economic Cooperation) meeting points out several main reasons that cause Small and Medium Enterprises (SMEs) facing obstacles in accessing a loan in Indonesia, namely:

- i. Products of banks do not match the needs and conditions of SMEs
- ii. Banks often overestimate lending risk to SMEs
- iii. High credit transaction costs for SMEs
- iv. SMEs are not able to fulfill banking technical requirements
- v. Limited access of SMEs to financial equity
- vi. Inefficiency in monitoring and collection of SMEs credit
- vii. Less effective technical assistance provided by the bank itself, therefore service cost for SMEs is high
- viii. The general bank is not used to financing SMEs.

Additionally, commercial banking, in general, creates complexity requirements for SMEs in accessing loans, particularly in terms of collateral and administrative conditions. It becomes obstacles for micro, small, and medium enterprises to start or to expand business productivity<sup>1</sup>.

One of the most successful conventional microfinance in Indonesia is the Bank Rakyat Indonesia (BRI) unit. Indeed, it is also known as one of the most successful conventional microfinance globally (Seibel, 2007). BRI unit is not only focusing on

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<sup>1</sup> a. Indonesia Delegation for APEC SMEs Ministerial Meeting, 2003; b. Timberg, A. Thomas. (1999). Small and Microenterprise Finance in Indonesia: What Do We Know? USAID-funded Partnership for Economic Growth (PEG) Project. The views expressed in this report are those of the author and not necessarily those of USAID, the U.S. Government or the Government of Indonesia.

micro, small and medium enterprises, but also on small vendors or economically active poor. Since October 2008, BRI expanded its banking activities by launching BRI Syariah as well as BRI Syariah Unit Mikro. Besides BRI Unit or BRI micro banking owned by the Indonesian government, Indonesia also has a variety of conventional and Islamic microfinance institutions. Both of these conventional and Islamic microfinance institutions particularly work for microenterprises with the profit or without profit motives (Ascarya, 2014).

The conventional micro banking unit owned by BRI noted as one of the successful microfinance institutions not only in Indonesia but also worldwide. However, BRI Syariah micro-unit is still left behind compared to others conventional and Islamic microfinance in Indonesia including BRI Microbanking Unit and Bank Syariah Mandiri (BSM) Warung Mikro in terms of sustainable microfinance model such as financial sustainability, unique characteristics, impact, and external shocks sustainability (Ascarya, 2014). Thus, there is a need to propose an Islamic microfinance model for BRI Syariah Micro Unit in order to achieve and expand its outreach not only for economically active poor but also for extremely poor. This study attempts to propose an integrated Islamic microfinance model for BRI Syariah Unit Micro in alleviating poverty and improving the performance of microenterprises.

This study comprises of five sections. Section 1 focuses on the introduction; section 2 presents the performance of PT. BRI Tbk and BRI Syariah Unit Micro; section 3 discusses literature review which focuses specifically on conventional and Islamic microfinance, previous studies on the impact of conventional and Islamic microfinance on poverty alleviation and performance of microenterprises, and poverty and Islamic microfinance. Section 4 presents the proposed integrated Islamic microfinance model in alleviating poverty and improving the performance of microenterprises, finally, section 5 discusses the conclusion.

#### *PT. Bank Rakyat Indonesia and PT. Bank BRI Syariah*

Bank Rakyat Indonesia (BRI) Tbk or Indonesian People's Bank is one of the most successful government banks in Indonesia, particularly in serving Small, Medium, and Microenterprises (SMMEs). In this regard, BRI distributes its SMMEs credit scheme through its BRI Microbanking. BRI noted that the distribution of credit scheme to the SMEs increased from Rp12.01 trillion or US\$ 12.01 billion in December 2002 to Rp27.28 trillion or US\$ 27.28 billion in December 2006 achieving an annual growth rate of around 22.77% per year. The Indonesian Government offered its shares, of around 30%, in BRI to the public on 10 November 2003. The price of BRI stock increased sharply on the Indonesian capital market from the time that BRI offered its stock to the public.

The profit of the BRI Unit before the financial crisis in 1995 was Rp403 billion (US\$174 million) compared to Rp65 billion in 1990. The Asian financial crisis 1997/1998 has minimal impact on the BRI Unit as its profitability continued to rise rapidly by around Rp1,161 billion after three years of the financial crisis in 2000. Although the profit of BRI Unit declined in terms of dollar value to around US\$121 million because of the depreciation of the rupiah against the US dollar value in 2000, but the BRI Unit had done very well financially by having profit around Rp2,168 billion (US\$233 million) and 6.2 of return on assets (ROA) in 2004.

BRI Syariah Unit Mikro is part of PT. Bank BRI Syariah. PT Bank BRI Syariah is generated from the acquisition of PT. Bank Rakyat Indonesia on Bank Jasa Arta on 19 December 2007. After obtaining the permission from Central Bank of Indonesia, it started operation on 17 November 2008 based on Syariah principles. On 19 December 2008, PT. Bank BRI Tbk gave full authority to PT. Bank BRI Syariah to operate its banking activities. It set out banking activities effectively on 1st January 2009. Recently, PT. Bank BRI Syariah chosen as the third biggest bank Syariah based on assets in Indonesia. It also noted as Islamic bank with good development in terms of assets,

amount of financing, and sources of fund from the third party. It focuses specifically on medium and low clients.

## 2. Literature Review

### *Microfinance Institutions: Experiences in Several Countries*

Microfinance institutions provides financial services in terms of very small loans, insurance, savings, and other financial services for clients with low income and the self-employed, which involve financial and social intermediations (ELLE, 2011; Karlan & Goldberg, 2007; Ledgerwood, 1999; Olu, 2009; Santos, 2003). Financial inter-mediation means savings and credit while social intermediation means group formation, self-confidence improvement, training in financial literacy, and management practices for the clients. Nine elements can be categorized as elements of micro-finance (Karlan & Goldberg, 2007). These elements are they exist in small loans, insurance or savings; loans accessed for business productivities; loans granted without collateral; lending based on the group; the intention being to reach poor clients; the process of application is uncomplicated; and the interest charged is based on the market level.

The objectives of microfinance are to alleviate poverty, to encourage female empowerment and serve poor clients, generate more employment, assist existing enterprises to expand their business productivity, and support the improvement of new businesses (Ledgerwood, 1999)., it could be concluded that microfinance not only plays a vital role in alleviating poverty but also in the development of microenterprises.

Microfinance emerged in the 1980s, resulting from the skepticism of government policy to deliver credit to poor farmers, and huge losses recorded by credit facilities operating based on subsidies given by donors (Ledgerwood, 1999). Microfinance was mostly subsidized by non-governmental organisations (NGOs) or the government, which moved from the status of subsidized credit to population targeting to serve poor people. MFIs would commonly have target clients such as that of Grameen Bank in Bangladesh which focuses on landless people, ACCION encourages the development of group lending based on solidarity for urban vendors in Latin America and Fundación Carvajal, while BRI focuses on the institutional approach based on the principle of market. During the 1980s and 1990s, much non-NGO microfinance and NGO microfinance increased significantly in providing microloans based on individual and group lending, such as PRODEM/BancoSol in Bolivia, K-REP in Kenya, and, finally, ADEMI/Banco ADEMI in the Republic of Dominica; which transformed into formal financial institutions offering savings services and accessing funds from market sources (Imboden, 2005; Ledgerwood, 1999).

A few MFIs also mobilised public savings after becoming formal financial institutions, such as the Bangladesh Rural Advancement Committee (BRAC) and ACLEDA Bank in Cambodia. Amanah Ikhtiar Malaysia (AIM) is also noted as one of the most successful microfinance institutions in delivering microcredit with the aim of alleviating poverty in rural and urban areas in Malaysia. AIM is a non-governmental organisation which implemented the Grameen Bank model for rural micro-financing (Saad & Duasa, 2011). Nowadays, numerous commercial banks, financial and insurance firms have moved into microfinance as wholesalers. They include multinational institutions such as Citigroup, Santander bank, Deutsche Bank, ING direct, ABN Amro Group, and Rabobank. Other institutions serve mostly their respective local and social markets such as the Oikocredit and Triodos banks<sup>2</sup> in the Netherlands, Blue Or-

<sup>2</sup> Oikocredit and Triodos banks are socially responsible investors who withdraw their self to microfinance due to its capability in providing the social and financial returns. Oikocredit is recognised by the United Nations and delivers finance for low-income countries to encourage micro and small entrepreneurs. It is one of the world's largest sources of private funding to the microfinance sector. It provides credit and equity to small businesses through MFIs across the developing world, and directly to trade cooperatives, fair trade

chard Finance in Switzerland and SHARE Microfinance Ltd<sup>3</sup> in Hyderabad in India (Imboden, 2005).

Islamic microfinance is a relatively new financial solution compared with the conventional microfinance, which emerges due to the weaknesses of conventional microfinance which charges the high-interest cost to their customers (Ledgerwood, 1999; Morduch, 2003). Based on these reasons, Islamic microfinance is viewed as a good solution by providing products based on an assets approach and not based on debt approach (Riwajanti, 2013). In this regard, Ascarya (2014) defined Islamic microfinance as an Islamic method to alleviate poverty, and the outreach is not only to the poor but also the extreme poor which never targeted by conventional microfinance. Meanwhile, Islamic microfinance defined as an institution offering financial and non-financial services based on shari'a principles with the purpose to advocate justice for everyone (Riwajanti, 2013). According to (Fadlallah, 2012) that the Islamic financial approach to poverty alleviation includes charity and development based interventions. It means that the Islamic financial approach is seen as more comprehensive than the conventional ones in the social field by providing two types of contributions, namely (i) It does not seek any material gain (zakat, Qard Hassan, etc), and (ii) It is profit-seeking and involves market-based services. He also defined Islamic microfinance as a type of microfinance that complies with the principles of Sharia by both prohibiting interest (Riba) and achieving welfare while avoiding unfair practices. Ahmed (2002) summarizes the differences between Islamic microfinance and conventional microfinance through table 1 below.

| Items   | Conventional Microfinance  | Islamic Microfinance   |
|---|--|--|
| Liabilities (Source of the fund)                | External funds, saving of clients                                  | External funds, saving of clients, Islamic charitable sources                                    |
| Asset (Mode of financing) Financing the poorest | Interest-based<br>Poorest are left out                             | Islamic financial instrument<br>Takes care of the poorest by integrating zakat with microfinance |
| Funds transfer                                  | Cash given   | Goods are transferred  |
| Deduction at Inception of contract              | Part of the funds is deducted at inception                         | No deduction is made at the inception  |
| Target group                                    | Women  | Family   |
| The objective of Targeting Women                | Empowerment of women   | Ease of availability   |
| Liability of the loan (Given to women)          | Recipient  | Recipient and Spouse   |
| Work Incentive of Employees                     | Monetary   | Monetary and religious   |
| Dealing with Default                            | Group/ center pressure and threat                                  | Group/center/spouse guarantee, and Islamic ethics  |
| Social Development program                      | Secular (non-Islamic) behavioural, ethical, and social development | Religious (includes behaviour, ethics and social)  |

**Table 1.** Differences Between Conventional and Islamic Microfinance

Source: Ahmad (2002)

Despite the differences, Islamic microfinance and conventional microfinance also have some similarities which include: (1) instill self-reliant and self-confident among the participants/clients, (2) provide financial services with the objective of achieving

organisations and small to medium-sized enterprises (SMEs). "FMO and Oikocredit Creating Opportunities in Low-Income Countries", <https://www.fmo.nl/k/news>.

<sup>3</sup> SHARE Microfinance Ltd is a regulated non-banking financial company (NBFC) which delivers financial and support services to the marginalised sectors in society, especially for the poor rural and urban women across India. SHARE helps women to become productive microenterprises, and it is indirectly giving contribution to the sustainable communities through its income-generating loans and business development services. <http://www.SHARELtd.com>

the principles of social justice, (3) link financial operations to the activities of real economy, (4) providing financial support, (5) depend on the principles of equality and non-exclusion, (6) give priority to the poor, the underprivileged and the marginalized over other groups, (7) refuse harmful activities, such as gambling, illegal business, and (8) provide strong support to entrepreneurs, especially when no collaterals are required in exchange for loans (Fadlallah, 2012).

In designing successful Islamic microfinance, three main instruments which are suitable in achieving the objectives of Islamic microfinance are Mudaraba, Murabaha, and Musharaka. While these instruments are available to be implemented in realising the ideals of Islamic microfinance, several studies have shown that Islamic microfinance faced several issues and challenges. A global survey indicated that the outreach of Islamic microfinance is very limited (Karim, Tarazi, & Reille, 2008). In this regard, Islamic microfinance has only served 300,000 clients through 126 Islamic microfinance institutions in 14 countries.

In this regards, Khaled (2011) argued that there are five main reasons which affect Islamic microfinance is still left behind compared to conventional microfinance, particularly in attaining more clients as much as conventional microfinance. These five core reasons are:

1) Focusing only on murabaha product

So far, Islamic microfinance institutions (IMFIs) have minimum Islamic financing product. Mostly they provide only Murabaha product. In the meantime, this murabaha product is criticized as the complex procedures in terms of additional cost and also about shariah compliance. Based on these reasons, it led IMFIs is still far away from conventional microfinance particularly in terms of limited products offered.

2) IMFIs have few experiences related to Profit and Loss Sharing (PLS) schemes

Khaled (2011) argued that players in Islamic microfinance should innovate new Islamic financing products by uniting all Islamic financial contracts, particularly on PLS products and avoid replicating business model which is originated from conventional microfinance. He also commented that new models built by players in IMFIs should ensure the transparency of the data and maintain cost efficiency.

3) Islamic microfinance has limited outreach in terms of number of clients

In Arab countries, the outreach of conventional microfinance in terms of the number of clients is more than Islamic microfinance. Conventional microfinance can reach lots of clients compared to Islamic microfinance.

4) Lack of financing resources compared to conventional microfinance

Khaled (2011) also noted that conventional microfinance has a lot of donations from donors compared to Islamic microfinance. It allows conventional microfinance to become more sustainable, and it also convinces commercial banks based on its historical performance that they are creditworthy. Thus, they can easily making use of loan from those banks, distributing these loans to their clients, and doing repayment with interest to the banks. It is not similar to Islamic microfinance. Islamic microfinance is still unable to build up the Islamic model based on profit-oriented in order to grasp more client as much as conventional microfinance and it also finds challenging to show their potential to the Islamic banks. Islamic banks are a reluctance to invest Islamic microfinance portfolio as they look at Islamic microfinance as a risky business. They only give them a loan with interest-free. It leaves IMFIs are trapped in financing sources.

5) Build up a new business model for Islamic microfinance

Practitioners of Islamic microfinance are expected to do innovation by creating a new model for Islamic microfinance. It is expected that business model should mix a variety of Islamic financing tools and contracts.

In this regard, we also discuss previous studies on the impact of conventional and Islamic microfinance on poverty alleviation and performance of microenterprises in the following section.

#### *Impact of Conventional and Islamic Microfinance on Poverty Alleviation and Performance of Microenterprise*

In assessing the economic impact of the microfinance program, the Ford Foundation of Development Finance Affinity Group found the Imp-Act (Improving the Impact of Microfinance on Poverty) in 1988. Imp-Act aims to receive information on poverty alleviation and evaluate results of microfinance investment. The types of impact of microfinance can be divided into two: direct impact and indirect impact (Copestake, Dawson, Fanning, Mckay, & Wright-Revollo, 2005). The direct impact covers income, assets, food consumption, health, and education. It also views the effect on the individual in terms of skills, knowledge, and self-esteem. Meanwhile, the indirect impact influences others besides the clients, such as family members, competitors, neighbors, and others at the community level.

Many previous studies have empirically examined the impact of microfinance on microenterprises and poverty alleviation. Various methodologies were used to measure the impact of microfinance on microenterprises and poverty alleviation. They are for instance the double-difference estimation between participants and non-participants and villages with and without microfinance programs<sup>4</sup>, the Index of Fulfilment of Basic Needs (IFBN)<sup>5</sup>, the two-staged least squares and Maximum Likelihood (MLE) test<sup>6</sup>, probit<sup>7</sup>, logit<sup>8</sup>, Tobit<sup>9</sup>, the Subsidy Dependence Index (SDI)<sup>10</sup>, the Heckman two-step techniques<sup>11</sup>, and others.

Other studies examined the impact of microfinance by reviewing various secondary data<sup>12</sup>. They focused on impact assessments of microfinance on poverty alleviation and microenterprises conducted in numerous countries, such as Bolivia, Indonesia, Bangladesh, and others including in a few developed countries. Results of impact assessment are mixed. Several studies show that microfinance has made an impact on the stability of microenterprises and poverty alleviation. However, some studies indicate that microfinance has no impact on microenterprises in terms of stability and expansion of businesses.

In this respect, some studies conducted in Bolivia indicate that microfinance institutions (MFIs) had a positive significant impact on income, employment, assets, technology, productivity, growth of clients, and sales revenue (Vogelgesang, 2001). However, they also illustrate that lenders of microfinance tend to only focus on poor people whose standards of living are close to the poverty line rather than poor people whose standards of living are below the poverty line as the latter are considered less creditworthy (Navajas, Schreiner, Meyer, Gonzalez-Vega, & Rodriguez-Meza, 2000). Furthermore, it also shows that microfinance has a negative impact on poor households who are low-risk takers and has a low return on investment (Mosley, 2001).

For the case of Indonesia, empirical studies have shown that the loan of MFIs has a positive impact on poverty and the performance of microenterprises. This demonstrates that MFIs, such as the BRI Units, Badan Kredit Kecamatan or Credit

<sup>4</sup> Coleman (1999,2006)

<sup>5</sup> Navajas, Schreiner, Meyer, Gonzalez, and Rodriguez-Meza (2000)

<sup>6</sup> Kaboski and Townsend (2005)

<sup>7</sup> Park (2001)

<sup>8</sup> Abiola (2011)

<sup>9</sup> Coleman (1999, 2006)

<sup>10</sup> Hulme and Mosley (1998)

<sup>11</sup> Kaboski and Townsend (2005)

<sup>12</sup> Shaw (2004); Agricultural Finance Corporation Limited (2008)

District Institution (BKK), Kredit Usaha Rakyat Kecil or Credit for Small Business People (KURK), and others have made positive impacts on job creation and household income (Yamauchi, 2005). Studies also illustrate that microfinance has a positive effect on the performance of microenterprises in terms of sales, and the standard of living of female entrepreneurs (Thio, Megananda, & Maulana, 2006). However, other studies indicate that microfinance has no impact on sales, profit or poor households (Morduch, 2003).

Similarly, studies carried out in Malaysia indicate that microfinance has made a positive impact on poverty alleviation and performance of microenterprises. (AL-Mamun, Wahab, & Malarvizhi, 2011), for example, demonstrated that microfinancing facilities from Amanah Ikhtiar Malaysia (AIM) have had a positive effect on assets of micro-enterprises owned by the hardcore poor. Saad & Duasa (2011) also demonstrated that the amount of microloans, which are accessed from AIM, has impacted significantly the economic performance of borrowers. AL-Mamun et al., (2011) illustrated that the current market value of livestock's agricultural or production equipments, agriculture stock, and raw materials, enterprise assets and motor vehicles owned by older clients are higher than new clients.

The empirical studies conducted in Bangladesh show that most of the loans of MFIs in Bangladesh, such as Grameen Bank, Bangladesh Rural Advancement Committee (BRAC), and others, have given positive effects on poverty alleviation in terms of household income, livelihood strategy, assets, production, employment, vulnerability, and female empowerment (Khandker, R. Shahidur Samad & Khan, 1998; Montgomery, Bhattacharya, & Hulme, 1997; Zaman, 2001). These studies also demonstrated that older client than to do better than new clients. Nonetheless, other findings have illustrated that the impact of microfinance on poverty is only positive for around six years, and it tends to even out after six years (Chowdhury, Alam, Ghosh, & Wright, 2005).

On the other hand, other findings also prove that microfinance has a positive impact on the more affluent microenterprises compared to poor microenterprises and that its impact on poverty depends on the location. In this regard, microenterprises in urban areas generally perform better than those in rural areas (Shaw, 2004). Some studies in India demonstrate that microfinance has a positive influence on generating employment for family members and non-family members; as well as on assets, savings, poverty alleviation, expenditures for food, health, education, and clothes; increase in income, source of income, stabilising normal income, and mitigating financial problems (Agricultural Finance Corporation Limited, 2008; Basu & Srivastava, 2005). Agricultural Finance Corporation Limited (2008) dan Basu & Srivastava (2005) also illustrate that on average, the household income of clients is more than those of non-clients.

The issue of the impact of Islamic microfinance on poverty alleviation and performance of microenterprises, however, remained largely unexplored. Riwayatanti (2013) stated that the impact of Islamic microfinance can be viewed from two sides, namely social and economic sides. Meanwhile, she also argued that Islamic microfinance was also able to eradicate poverty as it is debt-based. She further said that it will not make clients in a bad situation. Further, Obaidullah (2008) founded that Islamic microfinance is better than conventional microfinance in terms of growth, dropout rate, and operational efficiency compared in Bangladesh. He added as well that IMFIs provide spiritual training with the aim to increase client responsiveness on social right and accountability in enhancing the best relationship with others. Besides that, IMFIs also has a social impact as the number of clients increase in terms of drinking quality water and latrine for sanitation. However, Seibel (2007) contradicted with the previous studies on Islamic microfinance since he finds that Islamic microfinance is deficient of demand and Islamic banking skill. Further, he

demonstrated three main reasons behind the failure of the development of Islamic microfinance based on Indonesia study, namely:

- Most commercial banks have the ability in gaining Islamic banking knowledge by educating active and youthful people. However, commercial banks, in general, are deficient in terms of microfinance experience.
- Bank Perkreditan Rakyat Shari'ah (BPRS) or Islamic Rural Banks have been unsuccessful in proving themselves as the good supplier of Islamic microfinance services.
- Cooperatives are considered as an absolute hazard for their member-shareholders and depositors due to risk business in terms of losing money.

Also, there seems to be insufficient information to study the impact of Islamic microfinance in Indonesia. According to Seibel (2007), there has yet to be information related to the progress of Islamic microfinance for the last three years, except in Aceh.

It can be concluded from the previous studies that Islamic microfinance needs to be taken into account as one of the crucial tools in eradicating poverty and improving the performance of microenterprises. However, there are some factors or fields related with the development of Islamic microfinance need to be improved, particularly in terms of Islamic microfinance expertise, source of financing, client outreach, product innovation, the new model of Islamic microfinance, and also the need of government supervisory and regulatory.

#### *Islamic Microfinance and Poverty Alleviation*

Steidlmeier (1987) viewed that poverty is a troubling paradox since, in a moral sense, poverty is an injustice that derives primarily from the failure of collective human responsibility and it is unsettling in a political-economic sense because it breeds social instability and diminishes the possibility of improving the general quality of life. There are two broad concepts of poverty: absolute poverty and poverty. Absolute poverty is defined in terms of subsistence and is concerned with the provision of the minimum needed to maintain health and working capacity. Its terms of reference are the maintenance of physical health, the development of human capacities, and survival. The primary focus is meeting basic human needs.

Furthermore, Amartya Sen (cited in Steidlmeier, 1987) says that the key defining characteristics of poverty are that it is an absolute deprivation of a person's capacities. This means a failure to develop a person's ability to do various things which would ordinarily be within his or her reach. It touches physical, intellectual, artistic, communicative and other functional capacities and it is contrary with the approach of poverty which simply focuses upon baskets of commodities, incomes, and resources which will invariably lead to a relative notion of poverty since the necessities of life and the means to meet them are not fixed. Steidlmeier (1987) defined three definitions of relative poverty. They are:

➤ **Policy definitions of poverty that define a poverty line based on income**

Policy definitions of poverty represent a pragmatic effort to set social priorities and to implement policies to meet the set of social goals that a society may establish and such policies represent what is desired by those who exercise effective social voice and they usually result in the establishment of poverty lines which serve as guideposts to various social welfare benefits.

➤ **Relative disparities between income groups**

Poverty defined in terms of inequalities between income groups is concerned with the relative position of income groups to each other. The composition of society is seen as a strata of income layers, and relative poverty compares how those on the bottom fare with respect to those who are on the top. In this case, the focus is on social inequalities rather than on basic human needs.

➤ **Dynamically changing nature of human needs**

The relative notion of poverty is that human needs are dynamic, changing, and always reconstituting themselves. It follows that what is considered necessary or adequate to meet those needs is also always in flux.

According to Hasan (1997) the concept of a basic needs approach to development emerged as a consequence of the failure of the standard growth approach to check the spread of poverty and destitution in the developing economies. Besides that, to formulate meaningful programs for the purpose, poverty had to be defined in precise terms and the poor had to be identified accordingly. This was attempted through specifying a basket of goods which could be fulfilled at the minimum i.e. the basic needs of food, clothing, shelter, medicare, and education, to grant the recipients a living standard which society could accept as tolerable, if not decent. In this case, Hasan (1997) highlighted the absolute and relative versions of poverty within the Basic Need Fulfillment (BNF) program.

The idea of a physical basket of goods and services is considered to be an absolute version of the basic needs concept such as removing malnutrition in children, eradicating disease or educating girls, are concrete specific achievements that meet the basic human needs of the deprived groups, whereas reducing inequality is abstract. Another objection to a relative notion is that it defines poverty only in such a way that it may never be erased, despite any rise in the absolute income levels unless the measure of inequality is itself changed. He further said that since human stomachs do not differ much in size, the possible differences in the calories intake between the rich and the poor has a limit. Here, one may probably stretch the argument to accommodate an 'absolute' view of the requirement but that clearly cannot be the case with the other basic needs. For example, the size and equality of a shelter, and the range and level of the accompanying services relating to water, electricity, sewerage, transportation, etc can only be thought of meaningfully in some relative terms. Provision of services concerning health and education their quantum and standard is all the more difficult to conceive on an absolute basis. Poverty by its very nature is a relative concept.

There are some points of view about poverty and socio-economic development from contemporary Islamic scholars. Chapra (1985) (as cited in IDB reports) maintains that eradication of poverty, socio-economic justice and equitable distribution of income are considered as the underlying features of an Islamic economic system. Since the establishment of justice is one of the primary goals of Islam, and as such, the Islamic economic system should endeavor to eradicate all forms of inequity, injustice, exploitation, oppression, and wrongdoing. Furthermore, Siddiqi (1988) (as cited in IDB reports) asserts that in an ideal Islamic state, the basic needs of all in the society will be fulfilled. Zakat and waqf are expected to alleviate poverty and to develop the socio-economic system in Muslim countries. The Islamic point of view of poverty is that Islam does not only represent deprivation of goods and services but also lack richness/poverty in spirit (Mannan, 1988 as cited in IDB reports). The Qur'an says:

“ It is not righteousness that ye turn your faces to the East or the West, but righteous is who believeth in Allah and the last day and the angels, and the scripture and the Prophets, and giveth his wealth, for love of Him, to kinsfolk and to orphans and the needy and the wayfarer and to those who ask, and to set slaves free, and observeth proper worship and payeth the poor-due...Such are they who are sincere.

Such is the god-fearing. [ Surah al-Baqarah (2): ayat 177 ].

In this case, the verse above emphasises that the wealthier people must help the poor and needy. In Islam, the Muslims believe that they live not only in the world but also in the hereafter. They believe that life in the world is a test for them. Allah will give rewards or punishments to them based on what they have done in the world. By

doing so, the rich and the poor are required to behave in line with Shari'ah principles (Al-Qur'an and Al-Hadits). There are also some verses from Qur'an which ask the Muslims to make charity.

“ They ask thee (O Muhammad) what they shall spend, say; that which ye spend for good (must go) to parents and near kindred and orphans and the needy and the wayfarer. And whatever good ye do, lo: Allah is aware of it.” [ Surah al-Baqarah (2): ayat 215].

“ Ye shall never attain to goodness till ye give alms of that which ye love, and whatever ye give, of a truth, God knoweth.: [Surah Ali Imran (3): 86].

The verses above also highlight the important role of charity in an Islamic economy, where the rich people are expected to share their wealth with the needy and poor people. Islam strives to reduce inequality in income distribution and poverty. However, more often than not, poverty and income inequality are unavoidable due to economic crisis, political situation, calamity, and others. The Islamic approach to distributional equity is qualitatively different from the customary approach of making income distribution less skewed and more flat-topped.

In this case, Islam aims at preventing the emergence of the malady rather than treating it after its emergence. The elements of its grand scheme flow from its all-pervading concept of Amanah. Amanah underlines Islam's entire socio-economic philosophy and encompasses its program from the individual to the state. For spending in the way of God, the Qur'an uses the words *infaq*, *sadaqah*, and *zakah* as perfect synonyms. Redistribution is based squarely on Islam's worldview. God alone is the Creator and the true owner of everything. Individual income and wealth are truly trust and a test from God, even when it is earned with one's expert knowledge or the "sweat of one's brow." Poverty makes people unable to perform individual, social and moral obligation and, therefore the man is asked to seek Allah's protection from poverty, scarcity, and ignominy. There are seven major causes of poverty in present-day Muslim countries (Mannan, 1988). They are: (1) colonial exploitation in the past; (2) colonial legacy (the continuation of unsuitable development policies in the post-independence period); (3) Regional disparities and discrimination; (4) Neglect of human resources; (5) Economic dualism; (6) Financial dualism; (7) Inadequacies of the market system; (8) low labour productivity.

In view of this, Mannan (1988) provides some policy recommendations to eradicate poverty such as restructuring development policies to fulfill the needs of the rural population, providing extension services and necessary credit facilities to the farmers, land reforms and progressive taxation in addition to reactivating the tools of the Islamic redistributive policy. Poverty from the Islamic worldview indicated that the definition of poverty and wealthy is not only focusing on neediness of goods and services but also short of poverty character (Possumah & Ismail, 2011). Islamic jurists argued that it is the duty of the Muslim population to make sure the basic needs of the poor (Ascarya, 2014). There are several approaches for poverty eradication in Islam, namely: (1) Zakah; sadaqa jariya and waqf. These are compulsory and voluntary charities respectively; (2) In Islam, Muslim society is persuaded to become self-reliant including self-reliant in terms of monetary; (3) staying away from debt; (4) collaboration and unity among Muslim people; (5) Having family coherency in Muslim society; (6) Islamic microfinance product and contract must be based on shari'a compliance; and finally (7) Necessities of Islamic norms and best practices of microfinance in encouraging the progress of Islamic microfinance by combining charity and market based. Obaidullah (2008) stated that Islamic charities in terms of *shadaqa*, *zakat*, and *waqf* are considered crucial tools in eradicating poverty. *Shadaqa* is considered a common charity, while *zakat* is considered a compulsory charity. Finally, *waqf* is considered as the permanent charity which is applied for long-standing investment. It dedicates for

the poor in terms of health, education, employment, and physical resources (Hassan, 2010). Table 1 below points out the comparison among Islamic charity tools for poverty eradication based on Yumna and Clarke (2011).

**Table 2.** Islamic Charity Tools

|                      | <b>Zakat</b>  | <b>Shadaqa</b>                                 | <b>Waqf</b>   |
|----------------------|---|--|---|
| Compulsory/voluntary | Compulsory  | Voluntary                                      | Voluntary   |
| Rate                 | Fixed-rate  | Any amount                                     | Any amount  |
| Spend                | Spent in one year                                     | Spent in one year                              | Capitalized commonly  |
| Investments          | Not invested, need to be released as soon as possible | Not invested, released due to need and mandate | Invest in social and economic sectors                         |
| Time for payment     | Paid at any time, including Ramadhan                  | Paid at any time                               | Paid at any time  |
| Structure of payment | Paid in cash or stocks                                | Any types of assets                            | Any types of assets, including cash, land, coins, and jewelry |

Several Islamic banking instruments can be applied to supporting successful Islamic microfinance (IFAD (International Fund For Agricultural Development), 2011; Segrado, 2005) including:

- Murabaha sale is the commonly Islamic banking instruments used to support goods needed as working capital. Here, the financial provider will buy specific good which is needed by the customers in the market. Then, they will resell to the customers plus fixed fees charged as services.
- Musharaka and mudaraba. Musharaka refers to participation inequity in the business venture. Parties portion profits or losses based on predetermined proportion in terms of assets or working capital. Mudaraba denotes as a financing instrument which can be trusted. One party acts as a finance provider, and others act as an expert in the carried out project.
- Istisna'a. It denotes as an agreement of transfer between merchant and buyer in terms of selling an asset. The merchant can either fabricate the product themselves or acquire them from the third party. The final buyer can pay up in the lump sum process based on the agreement or in the diverse stages of the production process.
- Qard al Hassan is considered as a loan without interest-based. The borrower pays the principal amount of loan without interest-based charged. This type of financing is dedicated to the poor of the poorest people.

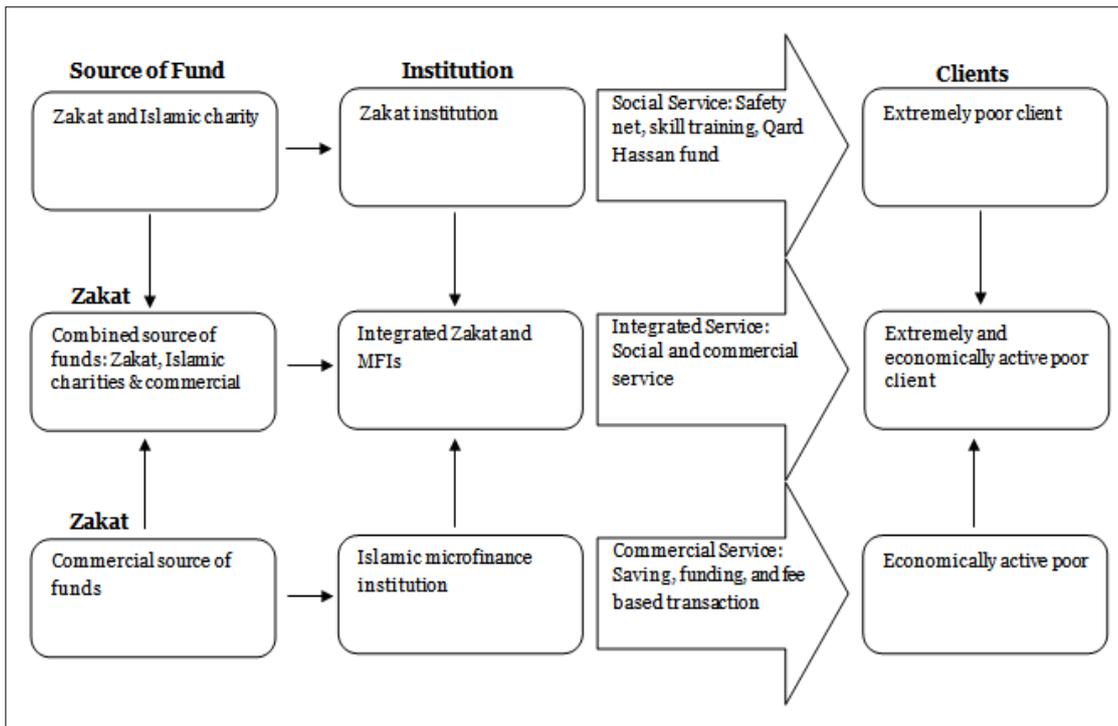
#### *A Review of Selected Islamic Microfinance Models*

Having reviewed the possible models for Islamic microfinance, this section presents the proposed integrated Islamic microfinance model for BRISyariah Micro for poverty eradication and development of the performance of microenterprise. Currently, there are various types of microfinance in the world, including (1) association model; (2) bank guarantee model; (3) community banking model; (4) cooperative model; (5) credit union model; (6) Grameen bank model; (7) Group model; (8) individual model; (9) intermediary model; (10) non-government organization (NGO); (11) peer pressure model; (12) rotating saving and credit association (rosca); (13) small business model; (14) village banking model; (15) self help group model; (16) graduation model; and (17) micro banking unit model (Ascarya, 2014). In the context of Indonesia, there are several microfinance models being successfully executed including (1) Grameen bank model which is replicated by various NGOs, cooperatives, Baitul Maal Wa Tamweels (BMTs), and venture capital; (2) Cooperative model which is duplicated by some cooperatives and BMTs; (3) Community banking model which is imitated by conventional and Islamic rural banks;

and (4) Micro Banking Unit (MBU) which is replicated by conventional and Islamic commercial banks.

In this regard, some scholars promoted several Islamic microfinance models with the purpose to build successful microfinance. Yumna & Clarke (2011) suggested an integrated model in building the success of Islamic microfinance in Indonesia. An integrated model involving two institutions, namely Islamic charities institutions including zakat and others; and Islamic microfinance institutions are presented. The sources of funds are originated from a mixture of zakat fund, Islamic charities fund, and commercial source of fund. Further, they stated that Islamic microfinance institution can present both social and commercial services by using a mixture of funds from a variety of institutions. Commercial services can offer numerous types of financial services including saving, funding, and product fees for economically active poor. Meanwhile, social services can provide skill training to improve capabilities of the extremely poor in executing business activities.

**Integrated Islamic Microfinance Model, Alleviating Poverty, Performance of Microenterprises**



**Figure 1.** Model 1: Integrated Model

Source: Yumna and Clarke (2011)

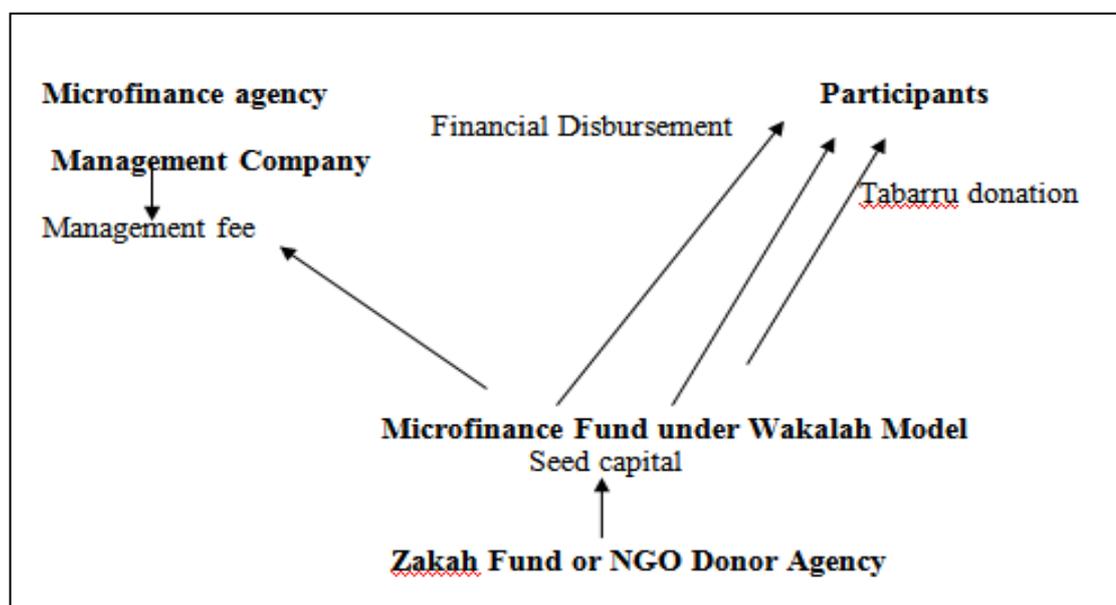
The essence of the above model is that the microfinance model above integrates zakat, other Islamic charities institution, and Islamic microfinance institutions. Several advantages of the model include: (1) Offering enough services for the extremely poor and economically active poor clients in terms of commercial and services; (2) Building sustainable microfinance as it does not only depend on donor funds, and also can offers numerous financial services in terms of saving, credit and other fees; (3) Improving accountability of those institutions as they have to write report to zakat institution, payers of Islamic charities, shariah compliance, and supervisory board of MFIs; (4) Building sustainable MFIs with at a low level of default rate and decrease the chance to misuse loan as the microcredit is only for skilled people; (5) Decreasing moral hazard or asymmetric problems as these institutions have similar objectives; (6) and finally Islamic microfinance use funds from donors as supporting funds of non-investment activities, and at the same time it becomes commercial microfinance attaining funds from commercial market.

Overall, this microfinance model is quite established as they offer commercial and social services for targeting clients, namely extremely poor clients, extremely and economically active poor clients, and economically active poor. Besides that, it is also

sustainable as the source of funds originated from Islamic charities institutions, including zakat, and also from Islamic microfinance institutions (commercial funds or from donors). However, these models need further improvement in terms of expanding the outreach in terms of targeting clients, variety of products and services, and the need for government regulation in building successful Islamic microfinance. In terms of targeting clients, this model not only focuses on clients based on an individual basis but also focuses on clients based on a family basis or family empowerment. This family client means husband and wife which are working together to earn money for their own family, and they are could be extremely poor clients, economically active poor, and; extremely and economically active poor clients. In terms of variety of product and services offered, they also should provide pension fund, Islamic insurance for health and children's education, and finally for pilgrimage. Further, there is a need for government support in terms of Islamic microfinance regulation from the central bank of Indonesia and shariah supervisory board for shariah compliance. At long last, authors should clear in giving limited time for skill training offered by these institutions, at least three months from a loan given.

Another Islamic microfinance model to be assessed is that introduced by Wilson (2008) This model is based on the wakalah and mudarabah contracts in promoting successful of Islamic microfinance. For wakalah agency model, source of fund is originated from zakah institution and NGO donors. The type of financing distributed to clients is in the form of Qard Hasan. In terms of credit application, staffs from this managing company act as an agent and evaluate the credibility of clients in receiving microloans. Fixed fees charged to the staffs as a reward in executing the micro-financing activity. This model is similar to the credit union but add some elements in terms of insurance for clients and quality financial administration. Further, he argued that this model is widely used in Islamic insurance or takaful for having tabarru (solidarity) fund as revenue accumulation among clients or participants.

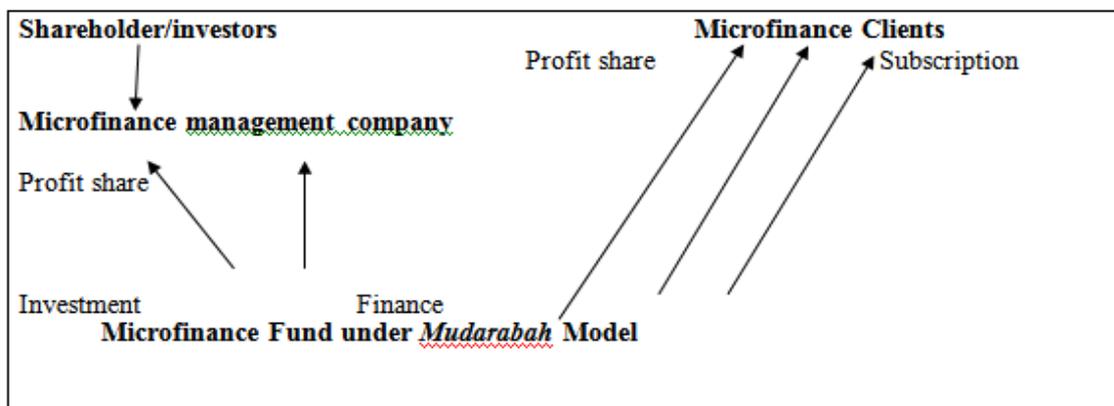
**Figure 2.** Model 2:  
Wakalah Agency  
Model



Source: Wilson (2007)

While Model 2 is practical from the implementation point of view, there are still some improvements needed for this wakalah agency model. Target-wise, it is still unclear of the specific targeting clients whether the participants or clients have come from extremely poor, economically poor, extremely economically active poor, or female clients. Further, this model does not provide specifically what kind of product and services offered to participants such as business skill training and saving the

Figure 3. Model 3: Mudarabah Model



Source: (Wilson, 2008)

Model 3, similar to the previous two models, has several limitations. This model does not offer saving protection as the fluctuated profit could result in no return in the venture. It is also unclear about the targeting clients whether focusing on economically active poor, extremely poor, female or family clients. It is not providing as well services product such as saving the product, business skill training, health insurance, and other services. Mudarabah model probably could create a moral hazard problem as the capability of clients in making repayment to the MFIs are not addressed.

Meanwhile, Possumah & Ismail (2011) promoted model 4 where zakat as the only source of fund for Islamic microfinance. They promoted Islamic microfinance model by integrating zakat as a capital provider with capital user or IMFIs'clients. In this regard, they argued that there are numerous benefits obtained from this model, including: (1) Reaching the poorest of the poor as poor people commonly are excluded from formal financial institution due to inability in doing repayment; (2) Doing assessment of the financial health of the poor as generally poor people use fund not for doing business productivity but for consuming good and services; (3) Aiding poor people doing transformation of unproductive assets become productive assets. Many poor people have land valued highly but they do not have fund to generate income; (4) Fulfilment of basic needs; (5) Zakat also has allegiance and enthusiasm on poverty eradication; (6) Need of technical assistance in connecting with zakah institution; and lastly zakah provides translucent accounting of operation activity.

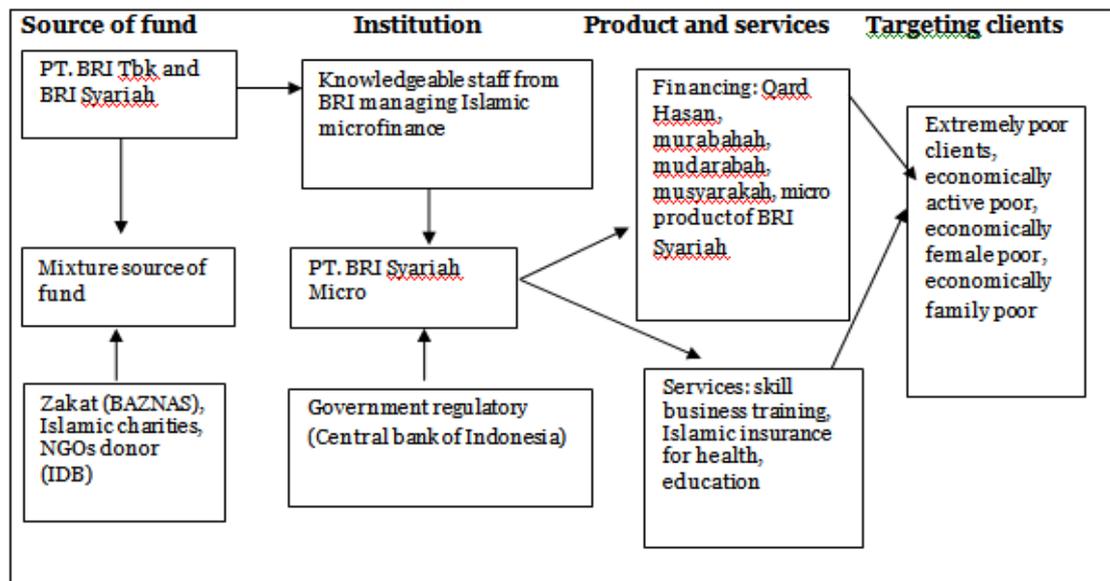
Further, they also argued zakah model working through three stages, namely: (1) Sources of fund is originated from Qur'an where the wealthy people must give their part for the needy and poor people in reducing gap between rich and poor people; (2) it is basic necessities for all of government and societies to take care fulfilment of basic needs of the needy and poor people, including needs for education and productivity; and finally (3) type of financing zakat is Qard al Hasan (benevolent loan) and used for productive purposes. Nonetheless, there are several flaws for their model. The type of target clients as to whether they are extremely poor, economically active poor, extremely and economically active poor, female poor, or family poor should be clearly identified. This model also could not depend heavily on

zakah fund as it is a charity fund which always has fluctuation or unstable situation causes fluctuation in terms of profit shared (Wilson, 2008). This model needs working together with commercial banking or Islamic banking in delivering Islamic microloan. This model does not provide as well services product in terms of skill business training, saving protection, Islamic insurance for health and education for clients targeting.

*An Integrated Islamic Microfinance Model for BRI Syariah Micro In Alleviating Poverty and Improving Microenterprise Performance*

Having reviewed the various models of Islamic microfinance, we propose an integrated model for BRISyariah Micro. Robinson (2005) stated that BRI is one of the successful commercial microfinance in the world, particularly through the Micro Banking Unit (MBU). However, BRISyariah, a unit of PT. Bank BRI Tbk established in 2009, is left behind compared Micro Banking Unit (MBU), particularly in terms of outreach. Also, BRISyariah is still far away compared to Bank Syariah Mandiri (BSM) Warung Mikro in terms of Islamic micro banking unit model (Ascarya, 2014). In view of this, following we would like to propose an integrated model for BRISyariah in building successful of Islamic microfinance.

**Figure 4.** Model 4: Proposed Integrated Model of Islamic Microfinance



Source: Authors' suggestion

Model 4 demonstrates an integrated model for BRISyariah in building successful of BRISyariah Micro. To ensure a financially sustainable model, BRISyariah integrates with Zakat (BAZNAS) institution, Islamic charities institution including waqf and sadaqah, and finally integrate with NGOs (donor) such as Islamic Development Bank (IDB) in providing a source of funds for targeting clients. Similarly important as a source of fund, PT BRISyariah Micro also requires knowledgeable staff from PT. BRI Tbk and BRISyariah in managing operation activities which is critical in developing a successful micro-finance program. Besides that, BRISyariah Micro need to be supported by Indonesia government through Central Bank of Indonesia (BI) in promoting Islamic microfinance for society in terms of the regulatory framework. It leads Indonesia society more realize the existence of Islamic microfinance, including BRISyariah Micro.

In terms of products, it is suggested that BRISyariah Micro should produce a variety of microfinance products that are shariah complaints that are appealing to a wide client-base. In terms of the financing product, it is not present only micro product originated from BRISyariah but also need provides Islamic finance product

such as mudarabah, murabahah, musyarakah, and Qard Al Hasan. In terms of services product, BRISyariah Micro also need to offer skill business training, Islamic insurance for health and education. Due to one of type of targeting clients is extremely poor, there is a need of skill business training in improving capability in doing business activities. Skill business training is also important for other types of clients in expanding their business productivity. Saving protection and Islamic insurance for health and education also regarded as a crucial tool in increasing standard of living of clients.

Further, targeting clients are comprise of extremely poor, economically active poor, economically female poor, and economically family poor. For extremely poor people, BRISyariah Micro need apply hiwalah contract. Hiwalah contract is a "transfer of debt from the transferor (muhil) to the payer (muhalalayh)" (Possumah & Ismail, 2011). It means that poor people as debtors or Muhil can transfer their own debt to the Muhal'Alaihi (payer or Islamic Microfinance). It leads to reducing the burden of the poor when they begin their business activity. They no need to feel worried as funds accepted only for paying the debt. For extremely poor and economically family poor, BRISyariah Micro need to provide credit union or sabiyah concept in delivering microloan in reducing default rate.

In summary, the current model proposed in this study is enriching to the existing models in the following aspects: (i)economic and; (ii)social aspects.

### 3. Conclusion

Islamic microfinance emerged due to high demand from Muslim countries. Currently, it is also considered as one of the crucial tools in eradicating poverty and improving the performance of microenterprises. Some scholars had been attempted to build a successful Islamic microfinance model by using Islamic financing instruments such as mudarabah, musyarakah, and murabahah. In this study, we attempt to build an integrated Islamic microfinance model by using BRISyariah Micro as a case study. It is expected that this integrated Islamic microfinance model can enrich existing models in terms of social and economic aspects.

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