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Why is Growth of Islamic Microfinance Lower than its Conventional Counterparts in Indonesia?

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Abstract

The aim of this paper is to examine the demand factors for microfinance services in Indonesia consisting of the understandings, perceptions and preferences of 581 micro finance institutions (MFIs) clients of four MFIs—two Islamic (BMT and BPRS) and two conventional (BRI and BPR).

The results show that MFIs clients' preferences are driven by economic (low interest rates, low collateral and size of loan) and non-economic factors (such as quality of services variables; easiness, speed, nearness, payment method and loan officers' profile). The results also indicate that BRI, a conventional MFI, is ranked the most competitive according to these factors, followed by BPRS (Islamic rural banks), BPR (conventional rural banks) and BMT (Baitul Maal wa Tamwil).

The survey also identifies the gaps in which Islamic MFIs should fulfill in enhancing their roles to reduce unemployment and poverty.

Key words: conventional MFI, Islamic MFIs, client's understanding, perceptions, preferences

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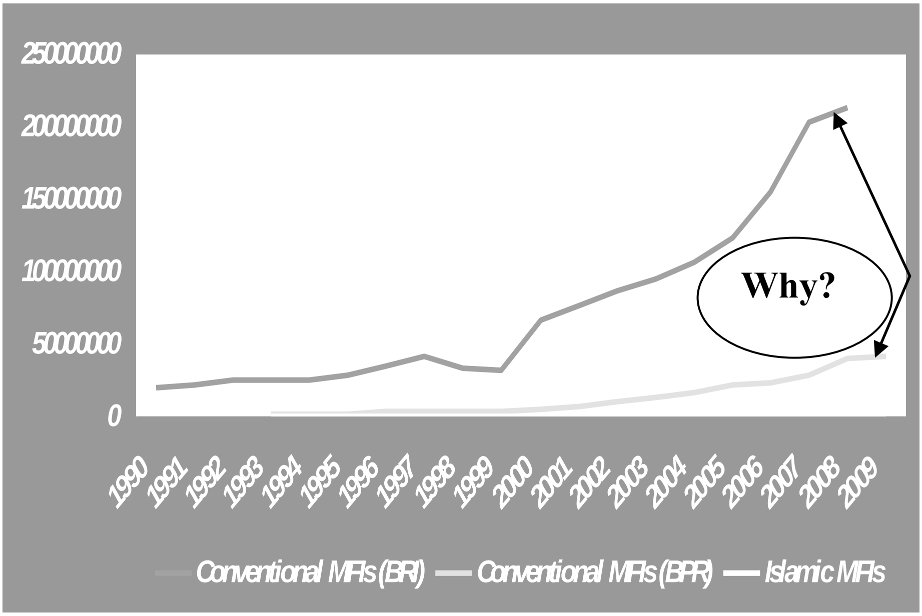
1. Background

Indonesia is the fourth largest country in the world in terms of population with 237.5 million people, with 88% of them being Muslims, making it the largest Muslim population country (based on 2010 Indonesian census). However, Indonesia also has other religions including Protestants, Roman Catholics, Hindus and Buddhists. Indonesian economy is dominated by micro, small, medium enterprises (MSME's) which together constitute 99% of the total business. Micro enterprises themselves dominate 98.85% of total business absorbing 90.98% of the total labor force and contributing 57.12% to GDP in 2010 (Indonesia Bureau Statistics, 2011). These figures show that micro-businesses play a strategic role in Indonesia economy. The Indonesian banking institutions are categorized into commercial and rural banks. In Feb 2011, there were 122 commercial banks and 1822 rural banks. Of the rural banks, the ones that are Islamic are only 151 with 291 total bank offices.

Indonesia has a diversity of both conventional and Islamic microfinance models. While conventional finance has existed for a long time, Islamic finance commenced in Indonesia relatively recently since 1990. As figure 1 shows, the growth of Islamic MFIs, however, has been sluggish and far behind the conventional MFIs. This research attempts to identify the client's understanding, perceptions and preferences toward MFI's products and institutions in order to understand why Islamic MFI grew slowly in Indonesia compared to conventional MFIs.

Figure-1
Gap between Conventional MFIs and Islamic MFIs



(Sources of data: Siebel's research, Bank of Indonesia's report, author's data processed from different resources)

While microfinance can be an instrument for poverty alleviation (Ahmed, 2004, 2007; Chapra, 2000, 2008: Kahf, 1999: Masyita, 2005, 2007) in reality it has not been used to its full potential. However, there is no single microfinance model or method that should be promoted. Every microfinance programme needs to be tailored specifically to meet complex local realities prevalent within each country or even different regions within a country. The needs of micro entrepreneurs, the complexity and nature of ventures to be financed are also the other reasons for doing this (Khan, 2008).

In this study, we report results from a survey of MFIs' clients conducted in Bandung, Indonesia. The population of the city and regency of Bandung is around 3.178 million. The study includes four MFIs, two conventional and two Islamic. The conventional and Islamic MFIs considered in the article include three non-governmental institutions BPR, BPRS, BMT and a governmental micro-banking institution BRI. The rest of the article proceeds as follows: In the section 2, the literature review on demand side issues of the microfinance sector is outlined. In the section 3, an overview of the poor and microfinance in Indonesia and some factors affecting it are presented. In the section 4, the research methodology, summary statistics of the data and analyses are provided. Section 5 reports the results from the survey. Section 6 concludes the paper and provides some recommendations.

2. Demand Side of Microfinance Sector

Contemporary microfinance evolved after developmental policies of the 1950s and 1960s failed to eradicate poverty. Not only did government rural credit schemes fail to reach small farmers (Hulme & Mosley, 1996) and the formal banking sector not fulfill the financial needs of low-income households there was concerted efforts to diminish the role of the state in economic development by cutting welfare spending such as basic healthcare and education (Fernando, 2006). In Muslim countries such as Indonesia, Bangladesh, Pakistan, many people do not deal with conventional interest-based financing due to their religious convictions. Thus, there is a need to establish Islamic microfinance institutions to include these people and fulfill their aspirations of *interest free* finance.

There are some economic problems for MFIs including asymmetric information, economic viability, low rate of return on investments (RoI), debt trap, high drop-out rate and non-graduation from poverty (Ahmed, 2002). As microfinance institutions deal with the poorer sections of the population who require small amounts of financing, the costs of delivery of the services become very high constraining their growth. As the size of the loan for micro enterprise is small, the administering cost of a per-unit of loan is high (Ahmed, 2007: 7; Obaidullah & Khan, 2008: 24). Furthermore, as clients of microfinance institutions do not have any track record, they are riskier than traditional financing portfolio. Therefore interest rates on microfinance are pegged relatively higher, since they entail higher risks, administrative charges and monitoring costs.

However, as asserted by Obaidullah & Khan (2008: 24) “easy to access, timeliness and flexibility are more important factors for micro entrepreneurs than interest rates”. Robinson (2009: 45), however, contradicts this when she states that “what matters to microfinance clients is the access and cost of financial services”. Ahmed (2007) maintains that microfinance institutions may find it difficult to attract deposits in the way that commercial banks do. As MFIs grow, however, the savings of beneficiaries accumulate, which can then be recycled in financing micro enterprises. Whatever the type of institution providing the finance, these institutions have to address the fundamental problems related to their operations and sustainability. To ensure income/revenue, these institutions have to mitigate the credit risk by ensuring that micro entrepreneurs repay the principal with returns in the absence of physical collateral and reduce the moral hazard problem. To be viable, the costs of operations have to be kept at a minimum (Ahmed, 2007).

There are some non-financial factors that have a significant impact on developing MFIs such as insufficient supervisory teams, low paid salary for officers, moral hazard problem, culture and specific behaviours. Sufficient supervisory and monitoring team compared with the number of clients is very important to increase the repayment rate. Wages paid to field level employees can affect their incentive to work and affect recovery rates (Ahmed, 2007: 7).

Some characteristics of micro entrepreneurs such as illiteracy, lack of collateral, the small size of the loan, the higher administering cost of loans (assessment, processing and monitoring) which make it impossible for traditional financial institutions to offer credit to micro enterprises (Ahmed, 2002; Khan, 2008). From the clients' point of view, the key words are "security, convenience, liquidity, confidentiality, access to credit, good service, and returns" (Robinson, 2009: 59) .

3. The Poor and Microfinance in Indonesia

This section first provides an overview of the poor in Indonesia and then discusses the nature of microfinance sector in the country. The results from the Bank Indonesia household survey in 2008 shown in Table 1 summarize the key economic variables for the household sector in the country.

Table 1 shows Indonesian households' assets can be divided into fixed assets 76.81%, non-financial assets 15.57% and financial assets 7.62%. Indonesian households' debt is mostly from banks constituting 78%, non-bank 12% and others 10% with the debt servicing ratio of banks being 72.11% and non-banks 33.08%. The purposes for which the households' take loan are business 24%, cars/motor 16%, property 14%, consumption 13%, education 8%, health 3% and others 4%. Moreover, households' repayment capacity ranges from 6.31% to 28.62%, with debt to assets ratio standing at 3.78% and debt to net worth ratio at 4.03%. These numbers show that there is a significant opportunity for MFIs to grow in the country.

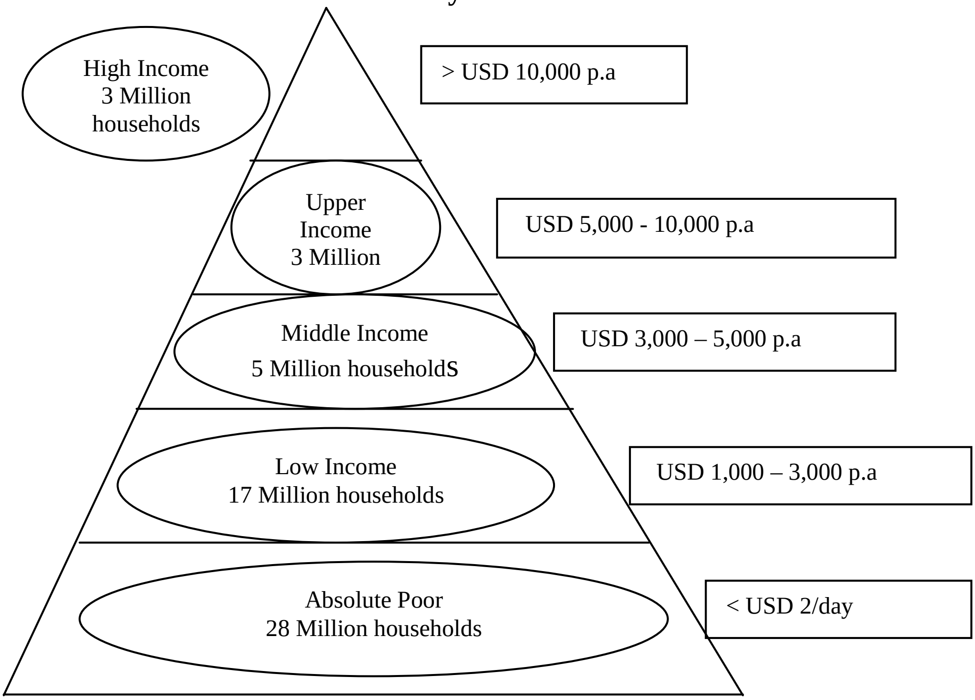
Table-1
Indonesian Household Survey

Assets		Liabilities	
Fixed Assets	76.81%	Debt from bank	78%
Non Financial Assets	15.57%	Debt non bank	12%
Financial Assets	7.62%	Debt other	10%
Total 100%		Total 100%	
Ratios			
Debt services ratio bank			72.11%
Debt services ratio non bank			33.08%
Repayment capacity range			6.31% - 28.62%
Debt to assets			3.78%
Debt to net worth			4.03%
Loan's Purposes			
Business	24%	Consumption	13%
Car/motor	16%	Education	8%
property	14%	Health	3%
others	22%		
Total		100%	

Source: Based on Bank Indonesia household survey in 2008

Indonesia's large population of 237 million people is housed in 56 million households. Figure 2 shows the spread of the households in different income groups. Middle to high income households with average yearly income range from USD5,000 - USD10,000 are the target highly competitive market of traditional retail banking by both local and foreign banks. The new target markets for microfinance/micro banking are low-income and the extreme poor households with average yearly income less than USD3,000. While the former group can be approached by commercial organizations with profit-oriented motives, the latter can be approached by organizations with social motives that are subsidized by either the government or NGOs.

Figure-2
The Income Pyramid for Indonesia



Source: Asian Banker 2004 (data as of Dec 2003)

Microfinance institutions are financial intermediaries which have core businesses in financing, capital accumulation, risk mitigation, payment and remittance systems and also provide funds to people at the lowest strata of the society. Compared to the 'financial system' approach identified by (Robinson, 2009), in which the MFIs operate with profit motives, the 'social approach' focuses welfare but have to depend on subsidies. Indonesia is dominated by 'financial system' approach whereby most Indonesian MFIs are motivated by profit rather than social amelioration. Thus Indonesia's MFIs do not serve all the people in the bottom of pyramid (i.e low income earners, micro entrepreneurs and poor inhabitants). They mostly serve the non-poor and rarely serve the core poor.

Microfinance markets are interesting in terms of profit and scale. According to CGAP's presentation 'Making sense of Microcredit Interest Rate', the yield on gross portfolio by scale of operation for large MFIs is 37%, medium MFIs 42.5% and small MFIs 42.8%. Four main types of financial institutions are engaged in the microfinance sector (Jansson, Rosales, & Westley, 2004):

(1) Commercial banks and other financial institutions opting for a strategy of 'downscaling'[1],

(2) Commercial banks and non-bank financial institutions specialized exclusively in microfinance,

(3) Cooperatives, and

(4) NGOs.

Fierce competition exists between microfinance providers in Indonesia where different institutions such as BPR, BPRS, BMT and also other large banks with their micro-banking division such as BRI (Bank Rakyat Indonesia), Andara, Mandiri, Mega, Mayapada, BTPN (local banks) and Citibank, Danamon, HSBC (foreign banks) and other commercial banks operate. This makes the cost of funds very competitive for micro-entrepreneurs. The MFIs include in this study include BRI which is type 1 institution in the above types; BPR (Bank Perkreditan Rakyat/rural bank) and BPRS (Bank Perkreditan Rakyat Syariah/Islamic rural bank) can be categorized as type 2 institutions; and BMT (*Baitul Maal wa Tamwil*) will be a type 3 Islamic Cooperative. Note that BRI, a state-owned commercial bank is fully supported by the Indonesian government and is a dominant player in the microfinance sector. It is noteworthy that BRI was recognized as a global microfinance institution giant in the Microfinance Summit 2005. There are two strategies employed by big banks in developing micro-banking. The first is to directly sell the products to the micro clients and the second to provide the services indirectly to the clients through other MFIs.

3.1. Types of Microfinance in Indonesia

Indonesia has a long history of providing finance in the rural areas with the first rural bank established in 1895. In 1910, there were over 13,000 rural banks. Bank Rakyat Indonesia (BRI), a state owned bank, was established in 1984 and BPR (Badan Perkreditan Rakyat/rural bank) was established in 1988. During the Asian financial crisis many large companies collapsed leaving a considerable amount of debt in the banking sectors. According to a 2005 report by the Asian Foundation, SMEs have been an important *engine of growth* for the Indonesian economy since 1997 (Musnidar & Tambunan, 2007). Since that time, banking sectors have put more of their investment portfolio into MSMEs and some of them became actively involved in microfinance through a linkage programme initiated by Bank Indonesia. This encouraged the big commercial banks to enlarge their lending to

[1] This type favours the creation of an internal unit specialized in microfinance sectors to reach a niche target. This unit is not the main activity of the banks.

MSMEs. Commercial banks took this opportunity by opening micro-service units in early 2003 which was also considered unfair to BPRs due to their scale of operations. However, the potential of the micro-credit market is still large[2]. It is not only banking sectors that have enthusiastically embraced the microfinance market, the Pegadaian (pawnshops with special privileges regulated by law) have also aggressively taken part as a state-owned company to provide these services. Pegadaian's (pawnshops) customers are obliged to pay a predetermined fee for safe-keeping the collateralized goods physically in the premises of Pegadaian by the employees.

According to Ismawan and Budiantoro (2005), Indonesian approaches to microfinance can be categorized into four kinds: savings-led microfinance, credit-led microfinance, micro-banking and linkage model. In savings-led microfinance, membership and active participation are pivotal. These organizations include self-help groups (SHGs), Credit Union (CU), and *Koperasi Simpan Pinjam*/*KSP* (savings and credit cooperative). Financial mobilization is based on membership and the capacity of the poor to contribute to savings. In credit-led microfinance, the key financial resource is not from savings mobilization of the members or poor but from other sources. BRI (People's Bank of Indonesia) and BPR (rural banks) are examples of micro-banking designed to provide micro-finance services.

The central bank, Bank Indonesia mandated to regulate and promote the development of banking in the country by Act 10 of 1998 and Act 23 of 1999. The linkage model, initiated by Bank Indonesia, is the starting point for collaborative ventures between commercial banks and BPRs since 2000. Both institutions have different natures that can be linked for mutual benefit: commercial banks have large amounts of capital and BPRs have experience dealing with micro-entrepreneurs. BPRs that lack funds but have more access to the poor can get access to financial support while commercial banks, which have more funds, can increase their number of clients (outreach). Supported by Bank Indonesia, this collaboration is widely well-known as *Pola Hubungan Bank dan Kelompok Swadaya Masyarakat/ PHBK* (Bank-Self-Help Groups Linkage) in 1988.

Akin to other commercial banking, Bank Indonesia as a regulator also applies a prudent microfinance institution for MFIs under its supervisory (BRI, BPR and BPRS only), the other hand, BMT is supervised under Ministry of Cooperative. One of the regulatory requirements for MFIs is to maintain non-performing loan

[2] Adapted from a local newspaper, Suara Merdeka, in a polemic debate according the commercial penetration into the BPR market in the middle of 2004

(NPL) to at most 5% overall. This policy is very useful in protecting MFIs from potential bankruptcy and ensuring their future sustainability.

The Directorate of Sharīʿah Banking, Bank Indonesia implements a comprehensive linkage model for Islamic microfinance. This linkage model foresees three types of intervention: “for-profit financial assistance, not-for-profit financial assistance and technical assistance for developing micro-enterprises. Islamic commercial banks get for-profit financial assistance for either their own division or jointly with the rural banks (BPRS) and/or BMTs” (Obaidullah, 2008: 79-80). Non-profit-financial assistance is provided by Islamic commercial banks in the form of *zakāh, infāq, ṣadaqah* and *waqf*. These funds are utilized to fulfil the basic consumption needs of the poor and to provide both training for unskilled micro-entrepreneurs and start-up capital for micro-entrepreneurs. Bank Indonesia provides technical assistance funds to various business development services providers and consultants in collaboration with universities. During 2006-2007, Bank Indonesia collaborated with Lembaga Manajemen Fakultas Ekonomi/LMFE (Management Studies Centres), University of Padjadjaran Bandung to conduct a pilot project involving Sharīʿah linkage for Islamic microfinance institutions in West Java and Yogyakarta Provinces. LMFE conducted this research and also provided support (spiritual, technical and managerial) for micro-entrepreneurs who obtained financing from Islamic rural banks (Masyita, *et al.*, 2011).

3.1.1. Conventional microfinance institutions

As indicated, two institutions providing conventional micro-financing, BRI and BPR are included in this study. A brief description of these organizations is given below.

3.1.2. Bank Rakyat Indonesia (BRI) microbanking

BRI, one the best known MFI in the world, is a state-owned bank and has had the best credit rating since 2008. As one of the largest MFIs in the world (Microcredit Year, 2005) in terms of the loan provisions and serving lower-income people, Bank BRI provides various services such as loans, savings products, insurance, and money transfer services/remittances. BRI can be categorized as a commercial bank which operates in the market doing massive volume of business by serving hundred million Indonesians who live in the rural areas. Loans are limited to USD 500 (IDR 5 Million) per client and given for a maximum tenor of 2 years. BRI provides individual-liability loans that are also non collateralized for the lower-income clients. Instead, BRI utilizes pre-existing relationship within communities by using the testimony of a respected community figure as social collateral on the borrower's loan are some reasons of BRI's success ingredients (Robinson 1992; 1994). This has enabled BRI to achieve the high repayment performance than schemes with social networks among borrowers.

Bank Rakyat Indonesia (BRI) has been successful due to various factors. Use of testimony and guarantee of community figures appears to have proven successful in Indonesia compared to group-lending schemes. According to Don Johnston cited in (Morduch, 2009: 18), "The main clients of BRI are petty traders or owners of small enterprises like restaurants and tailor shop, typically making high margin, quick turnaround investment who have capabilities to pay real interest rate". Furthermore, "BRI's scheme had developed product that have enabled it to work profitably with low-income households and it is more convenient for bank clients" (Arun, Hulme, Matin, & Rutherford, 2009: 11). As a profit making enterprise, BRI's efficiency is also achieved through transfer prices in subsidized programs, whereby "the internal prices used by institutions to value capital and determine relative performance at branch levels"(Morduch, 2009: 27). Bank BRI Units savings products are based on principles of trust, security, convenience, liquidity, privacy, linkages with loans and returns (*Microfinance Industry Reports - Indonesia*, 2009: 11). Robinson (2009) asserts that sustainability in the long-term requires a financial approach and BRI have showed that it can reach the active poor clients.

3.1.3. BPR (Badan Perkreditan Rakyat)/ Rural credit banks

During the nineteenth century Dutch colonial rule in Indonesia, rural credit banks were established as Lumbung Desa, Bank Desa, Bank Tani, and Bank Dagang Desa. The main objective of these banks was to help workers not to fall into the debt trap of high interest rates from moneylenders. During the post-independence period, some types of small financial institutions were established in the rural areas such as Bank Pasar (Market banks), Bank Karya Produksi Desa (BKPD). In the early 1970s, Lembaga Dana Kredit Pedesaan (rural credit fund institutions) were established by the local governments. Subsidized credit has been provided to SMEs since the 1970s. The credit programmes are called small investment credit (*Kredit Investasi Kecil,* KIK) and permanent working capital credit (*Kredit Modal Kerja Permanen, KMKP)*. In 1988, the President of the Republic of Indonesia decreed Paket Kebijakan (Policy package) October 1988 (PAKTO 1988) through President's decision no.38 which further gave momentum to establishing rural credit banks.

The Directorate of Economics and Monetary Statistics of Bank Indonesia Jakarta divides rural banks into three sub-groups namely: (a) BPR non-rural, i.e. new BPRs, petty traders/village banks, BKPD, and employee banks, (b) BPR rural, i.e. village banks, *paddy banks*, and (c) LDKP. The key success of rural financial intermediation systems in Indonesia comes from the design of their organization. If the commercial banks can be owned state companies and the private sector, most of the BPR's owners are private individuals. The first BPR (Badan Perkreditan Rakyat) established in 1988 with minimum capital requirements were IDR 50 million or equivalent to USD 29,000. Since then, there have been three major types of BPR: newly established institutions, converted BPR and conversions from other MFIs.

BPR is a financial intermediary for lower-income people and the poor that being regulated and supervised by the central bank. The target markets of BPR are mostly rural and suburban people who are not served by large commercial banks. BPR is characterized by easy access and simple administrative procedures for the villagers. Mostly, BPRs are located close to markets and focus on people's unique needs of particular areas. As a supervisor of BPR, Bank Indonesia has facilitated linkages between commercial banks and BPR.

From 2001 to July 2006, 249 BPRs were closed and the remaining 306 BPRs were merged into 26 BPRs (post-merger); 95% of merged BPRs were owned by the local government. Nevertheless, during the crisis, the proportion of bankrupt BPRs was lower than the proportion of bankrupt commercial banks. A challenge for BPR is the government policy encouraging larger private and owned-state companies to use a part of their profit to finance SMEs. Therefore, through their Corporate Social Responsibility/CSR's program, private and state-owned corporations prefer lending directly to MSMEs, instead of using existing BPRs. To gain political advantage and be "good neighbors", large corporations provide credit to SMEs at low interest rates (6% interest rate flat). For example, the biggest companies in Indonesia, Telkom, Pertamina, Krakatau Steel, Indonesia Harbor and other stated-owned companies disbursed revolving soft loans at 6% p.a. to SMEs. At the same period, BPRs provide credit with an interest rate of 30% per annum. As the result, it is quite difficult for BPR to compete with the big state-owned corporations in term of interest rate of credit in the particular areas in Indonesia.

3.1.4. Islamic microfinance institutions

Given Bank Indonesia's mandated to regulate and promote the development of banking, it is actively involved in promoting Islamic banking and Islamic microfinance institutions. There are three types of Islamic banking institutions in Indonesia; fully-fledged Islamic commercial banks, Islamic banking units of commercial banks and Islamic rural banks (BPRS). On the liability side of rural banks, clients deposit in *muḍārabah* accounts on profit-loss sharing basis. On the asset side, the bank invests in various assets using different sale, lease and equity modes of financing. Islamic MFI finances only real transactions with the underlying assets and any debt created is backed by collateral. To minimize risks, usually the well-performing existing clients are financed. Evidence, however, shows that the development of Islamic microfinance has not been smooth and the reality is different from the expectation.

The Islamic MFIs considered in this paper are briefly discussed next.

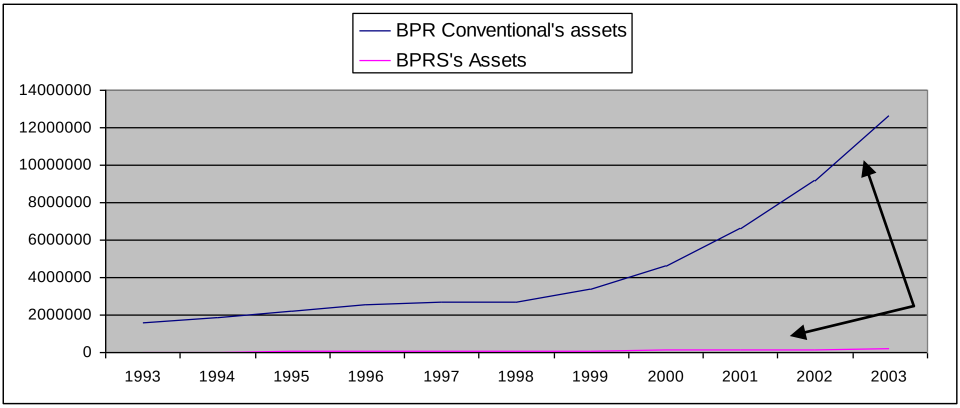
3.1.5. Bank Pembiayaan Rakyat Syariah (BPRS)/Islamic rural bank

Bank Pembiayaan Rakyat Syariah (BPRS) is regulated by National Act No.7/1992, amended by National Act No.10/1998 (*Peraturan Bank Indonesia tentang Badan Perkreditan Rakyat*, 2004: 3). BPRS are supervised by the central bank, Bank of Indonesia. "BPRS were first licensed in 1991, after a technical team based on decision of *ʿUlamāʾ* on the prohibition of *ribā* was formed and steps were taken to established Islamic commercial and rural banks" (Seibel & Agung, 2005: 15). Thus, Islamic rural banks (BPRS) came into existence in 1991, two years after conventional rural banks (BPR) first started in 1989.

According to Seibel and Agung (2005), there is no significant effect on to the preferences of Indonesian Muslims towards Islamic banking after the issuance of *fatwa* from the Indonesian *ʿUlamāʾ* Council (MUI) on the prohibition of *ribā* according. The historical data shows that the growth of Islamic rural banks has been far behind the conventional ones in a country with 88% Muslim population.

Specifically, Seibel and Agung (2005) show that conventional rural banks have grown more than 20 times faster than Islamic rural banks on a yearly basis. After a promising start in the early 1990s, the development of Islamic micro-banks has almost come to a standstill. An initial period of growth until 1996 when their number reached a total of 71, their growth almost stagnated during and after the financial crisis, reaching 78 by 1998 and a mere 84 by 2003 (out of a total of 2,134 rural banks).

Figure-3
Differences between BPR (conventional) and BPRS (Islamic) Assets



3.1.6. Baitul Maal wa Tamwil (BMT)

Fast growing microfinance institutions are those that gain support politically and are socio-religiously accepted. One of these institutions *Baitul Maal wa Tamwil* (BMT) serves the grassroots segment, majority of who are Muslims, by implementing Sharīʿah compliant financing. Beyond the reach of Bank Indonesia, BMTs are cooperatives and have grown rapidly in the aftermath of the banking crisis, reaching more than 3,000 units in 2010. The development of Islamic banking has been complemented by that of Islamic financial cooperatives, or BMT. The first Islamic cooperative, Ridho Gusti, was established in 1990 in Bandung. The first Islamic cooperative was established in 1990. Rapid expansion started after 1996, as a result of promotion by Center for Micro Enterprise Incubation (PINBUK), a non-government organization, and continued throughout the financial crisis, but stagnated after 1999 at around 3,000 and then declined to less than 2,900 as of 2003 (out of a total of some 40,000 microfinance cooperatives) (Seibel, 2008: 90)Seibel & Agung, 2005: 19).

Seibel & Agung (2005) found that "BMT (*Baitul Maal wa Tamwil),* comprising about 95% of Islamic cooperatives, affiliated to Nadhatul *ʿUlamā'* (NU), which is, with almost 40 million members, the largest Islamic mass organization in Indonesia". They further said that NU does not play an active role in guiding and supervising BMTs, which are under the guidance of PINBUK. It should be noted that statistics on BMT usually include the BTM (unless otherwise stated). "BTM *Baitul Tamwil Muhamadiyah*, comprising about 5% of Islamic cooperatives, guided since 1999 by Muhamadiyah, which is the second-largest

Islamic mass organization in Indonesia with some 25 million members. BTM are informally supervised by PPEM" (Seibel & Agung, 2005: 13). The Ministry of Cooperatives does not register cooperatives as Islamic or conventional and provides no information or special assistance to Islamic cooperatives. In sum, the outreach of Islamic cooperatives was negligible, and then, their overall performances were poor. Issues related to BMT include lack of regulation, supervision and reliable reporting, large majority of Islamic cooperatives are dormant or technically bankrupt, the savings of the depositors are at great risk (Seibel, 2008).

4. Research Methodology

To study the relative understandings, perceptions and preferences of conventional and Islamic MFI's clients, a survey on 28 BPRs, 17 BPRS, 64 BRI Units and 8 BMTs in Bandung was conducted in 2010. However, Bandung is one of hundreds of cities in Indonesia and cannot represent the characteristics of the country in general. However, almost all ethnic groups in Indonesia can be found in Bandung. People who live in Bandung are multi-cultural with varying educational backgrounds. Bandung has the highest density of population in Indonesia. More than one thousand micro, small and medium enterprises underpin Bandung as a tourist destination and an education city in Indonesia.

The aim of this study is to investigate the gap in the growth between conventional and Islamic MFIs based on understanding, perceptions and preferences the clients of these institutions. The objectives of this study are (1) to identify the profile of MFI's clients, (2) to explore MFI's clients' understanding, (3) to explore MFI's clients' perceptions, (4) to explore the preferences of MFI's client, and (5) to identify the reasons behind choosing a MFI. As the MFIs clients are dispersed in a large area in Bandung, multi-stage cluster sampling was used. One of the researchers along with four surveyors divided the area into six zones, and interviewed 110 randomly selected MFIs clients at each area. In this research, probability sampling designs are preferred because such designs give each MFI's client chance of being selected. The list of the MFI's clients was given by MFI officers to the researcher. Based on those data, the interviewers selected them randomly. In the field, this technique is hard to apply due to many reasons such as respondent's reluctance to be interviewed, the difficulty to arrange a meeting time, and use of more money and time. In the beginning, the respondents are chosen randomly based on the list and after one month the surveyors visited the respondents in the traditional markets which is spread across the city. Most traders in traditional markets are MFI's clients. Another place where it is quite easy to find

MFI’s clients is government institutions. From 650 questionnaires distributed, 603 MFIs clients responded from which only 581 questionnaires were deemed appropriate and complete to be processed statistically.

5. Results

5.1. Profile of Microfinance Clients

As shown in table 2, the proportion of male (56%) is greater than female (44%) for the whole sample. However, results from BRI shows otherwise with female numbers being much more than men.

Table 2
Gender of MFIs

		Gender of MFI's Client		
	MFI	Female	Male	Total
MFI's Clients	BMT	43	64	107
	BPR	43	100	143
	BPRS	53	70	123
	BRI	115	93	208
Total		254 (44%)	327 (56%)	581

The majority of MFI clients’ ages range was between 30 and 41 years old (56.5%), followed by clients aged between 42 and 52 years old (28.5%), younger clients with ages up to 30 years old (13%) and only 2% of the sample were aged over 53 years old (see Table 3).

Table-3
Age of MFI’s Clients

		Age of MFI's Client				
	MFI	< 30	30 – 41	42 – 52	53+	Total
MFI's Clients	BMT	15	64	26	2	107
	BPR	29	85	27	2	143
	BPRS	18	68	34	3	123
	BRI	14	110	78	6	208
Total		76 (13%)	327 (56.5%)	165 (28.5%)	13 (2%)	581

Data shows that MFIs tend to give loans/financing to younger clients. It is reasonable to finance clients in the productive age group more than other age group. However, the clients of the microfinance sector are expected to be riskier compared to the banking sector as they are involved in micro business and lack collateral. However, it is different with BRI which has a higher percentage of clients in the group 42-52 years old.

Table-4
Jobs of MFI's Clients

		Job of MFI's Client			
		Government Employee	Others	Private	Total
MFI's Clients	BMT	7	46	54	107
	BPR	11	66	66	143
	BPRS	5	56	62	123
	BRI	85	84	39	208
Total		108 (19%)	252 (43%)	221 (38%)	581

Table 4 shows that the majority of clients in the sample (43%) work in the informal sector as petty traders, micro entrepreneurs and peasants jobs followed by private companies (38%) and the government sector (19%). It is clear that BMT, BPR and BPRS do not choose government employees as their target market and they deal mainly with private and informal sectors. These MFIs are active in the high-risk market but with potential higher returns. Interviews with the clients reveal that to get loan/financing from these MFIs, the clients have to deposit a key document such as education certificate, estate ownership document, car/motor ownership certificate, employment status document or other valuable documents as collateral. Without putting one of these collaterals, it is impossible to get a loan.

BRI can give a client a lower interest rate as long as the government or company offices have prior mutual understanding or an agreement with the BRI. BRI requires a guarantee from a government or company treasurer that every month their salary would contribute towards the loan payment directly. This can be done by BRI as it is a state bank, which puts it at an advantage to overcome the fierce competition among MFIs in Indonesia. Thus, BRI's largest target market the government employees have particular characteristics: a fixed income, the lowest risk and lower monitoring costs.

Table-5
Duration of MFI's Loan

		Duration of MFI's Loan (year)					
	MFI	< 1	1-2	2-3	3-4	4-5	> 5
MFI's Clients	BMT	59	17	14	7	9	1
	BPR	115	17	4	0	4	3
	BPRS	51	42	25	1	1	3
	BRI	65	30	34	10	50	19
Total		290 (50%)	106 (18.25%)	77 (13.25%)	17 (3%)	64 (11%)	26 (4.5%)

Table 5 shows that the majority of loans had durations of less than one year (50%), followed by duration of 1-2 years (18.25%), 2-3 years (13.25%), 3-4 years (3%), 4-5 years (11%) and more than 5 years (4.5%) respectively. The short-term loan is the dominant type of financing for BMT and BPR. Short-term loans/financing implies that the clients use the loan for emergency or consumption needs. It is unlikely that they would be able to build a robust business in a year or less that can yield high profits. BPRS and BRI spread their loan/financing in terms of duration. Note that the duration of loans can also affect the cost of financing.

Table-6
Size of MFI's Loan (million IDR)

		Size of MFI's Loan (million IDR)									
	MFI	<1	1-3	3-5	5-10	10-20	20-30	30-40	40-50	50-100	>100
MFI's clients	BMT	10	40	12	18	6	9	6	5	1	0
	BPR	1	69	44	14	6	2	1	3	3	3
	BPRS	0	29	27	22	15	9	4	5	12	0
	BRI	17	35	14	12	19	41	17	29	24	3
Total		28 (5%)	173 (29.5%)	97 (16.5%)	66 (11%)	46 (8%)	61 (10%)	28 (5%)	42 (7%)	40 (7%)	6 (1%)

There are various sizes of loan of MFI's clients. The majority of loans (29.5%) were between IDR 1 million (USD 100) – IDR 3 million (USD 300) and the least (only 1%) were in more than IDR 100 million (US D10,000) category. BMT focuses its financing between IDR 1 and 3 million (USD100 - USD300), BPR in the IDR 1 and 5 million (USD100 - USD500) range, and BPRS's financing ranges between IDR 1 and 10 million (USD100 - USD1,000). The loans provided by BRI covers a long range of less than IDR 1 million to more than IDR 100 million (<USD100 to > USD10,000). A staff of BRI indicated in an interview that it is not constrained by funds and lends to clients as long as they fulfill all the prerequisites and pass the screening application process. The BRI units can request additional funds from the headquarters if there are potential customers. This is another advantage of BRI compared to other MFIs.

Table-7
Frequency of Loan

	BPR	BPRS	BMT	BRI	Total
Once	120	75	52	90	337 (58.11%)
Twice	9	17	22	46	94 (16.21%)
Three times	6	12	16	28	62 (10.68%)
Four times	4	13	13	29	59 (10.17%)
More than four times	3	6	4	15	28 (4.83%)
Total	142	123	107	208	580 (100%)

Table 7 shows that only 4.83% of MFI clients in the sample received loans more than four times and 10% of clients received loan four times. The majority of the client (58%) received financing once, 16.21% received loans twice and 10.68% received loan three times. Most of the first-time clients got their loans from BPR, followed by BRI, BPRS and BMT. It is interesting to note that only a small number of clients get their second round of financing from MFIs in general and BPR and BPRS in particular. It seems that after evaluating the first loan cycle, only a small number of clients who qualified to get the second loan. This is confirmed by the loan officers who said that it was very difficult to get good clients who had sustainable small or micro businesses. The loan officers claimed that although most of the MFI's clients indicate that the purpose of financing is to use it for working capital or buying fixed assets to support their business (see also Figure 4), many use the money for consumption or emergency needs. In the above is true then BPR appears to have the highest risk clients followed by BPRS as the drop from the first and second loans are the highest for them. BRI shows a relatively stable pattern retaining the most clients in subsequent periods.

When MFI's clients are asked about the purpose of their loan/financing, see Figure 4 shows that 50% of them responded it to be for working capital and fixed assets, 23 % of client stated for working capital only and 14% of client stated to buy fixed assets. A minority (13%) of the clients indicate that they used the loan for consumption purposes. Again, when the researcher interviewed the clients about the real use of the loan/financing, most of them said that they needed it for emergency (such as to cover hospital costs for family member, pay admission fees for school, pay off other debt, etc.) and consumption (such as down payment for a motorcycle, a new TV, hand phone, etc.). They wrote 'working capital or fixed assets' on the application form so that they could get the financing as soon as possible.

Figure-4
Purpose of MFI's Loan

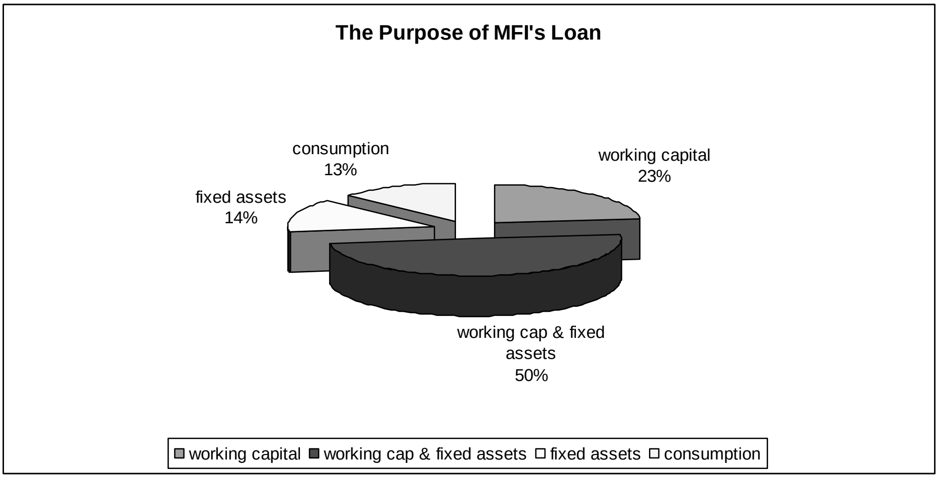


Table-8
Average Interest Rate/Cost of Fund

	MFI	Monthly Average Rate
MFI's interest rate	BMT	1.68%
	BPR	2.73%
	BPRS	2.02%
	BRI	1.46%

Table 8 above demonstrates the average monthly interest rate/mark-up/rate of return charged by MFIs. Note that rates not only vary from one MFI to another in Bandung and also among clients in a single MFI as well. This figure was obtained based from the answers of MFI clients from the survey. As the client job profiles show in Table 4, BPR, BPRS and BMT compete with each other to attract new potential clients from a similar background. The level of competitiveness among MFIs in Bandung particularly BPRs, BPRS, BMTs and other cooperatives to attract clients is high but they still cannot compete with BRI's low interest rates. As indicated, BRI is a state bank fully supported by the Indonesian government with many cross subsidy programs has a relatively less risky client base and, as such, can charge a lower interest rate. Note that while Islamic MFIs, BPRS and BMT's have similar clients to the conventional MFI BPR, the rates they charge is quite moderate compared to the latter.

5.2. Clients' Understanding Towards Islamic Microfinance Products

The survey included questions about the clients' understanding of Islamic microfinance products. In general, the majority of MFI clients did not understand financing modes and the concept of Islamic banking or microfinance products as can be seen in Table 9 below.

Table-9
Understanding of Islamic Banking Products

		Understanding about *Murābaḥah* concept		
		No	Yes	Total
MFI's Clients	BMT	53	54	107
	BPR	139	4	143
	BPRS	54	69	123
	BRI	179	29	208
Total		425 (73.15%)	156 (26.85%)	581
		Understanding about *Muḍārabah* concept		
		No	Yes	Total
MFI's Clients	BMT	55	52	107
	BPR	140	3	143
	BPRS	87	36	123
	BRI	187	21	208
Total		469 (80.72%)	112 (19.28%)	581
		Understanding about *Mushārakah* concept		
		No	Yes	Total
MFI's name	BMT	61	46	107
	BPR	143	0	143
	BPRS	98	25	123
	BRI	197	11	208
Total		499 (85.88%)	82 (14.12%)	581
		Understanding about *Ijārah* concept		
		No	Yes	Total
MFI's Clients	BMT	75	32	107
	BPR	143	0	143
	BPRS	88	35	123
	BRI	194	14	208
Total		500 (86%)	81 (14%)	581

The results on understanding to different Islamic finance products in Table 9 show a low level knowledge on most of the Islamic financial instruments. Of the modes, *murābaḥah* is the most familiar to MFI clients. Nonetheless, it was only understood by 26.85% of the respondents. As expected, the clients of Islamic MFIs appear to understand the concept better than the conventional ones. Specifically, both Islamic MFIs (BPRS and BMT) have an almost equal number of clients who understood and who did not. However, the clients of two conventional MFIs (BPR and BRI) show that an overwhelming majority did not understand *murābaḥah* Knowledge about other modes of financing is even worse. A total of 80.72 % of respondents did not understand the *muḍārabah* concept. Only clients of BMT show an almost equal balance between respondents who understood and who did not. Akin to two Islamic banking products above, *mushārakah* showed the same pattern with the previous products. BMT demonstrated slightly different numbers between clients who understood and who did not. Similar results are found for *ijārah* products with only a small number (14%) of clients who understood the concept.

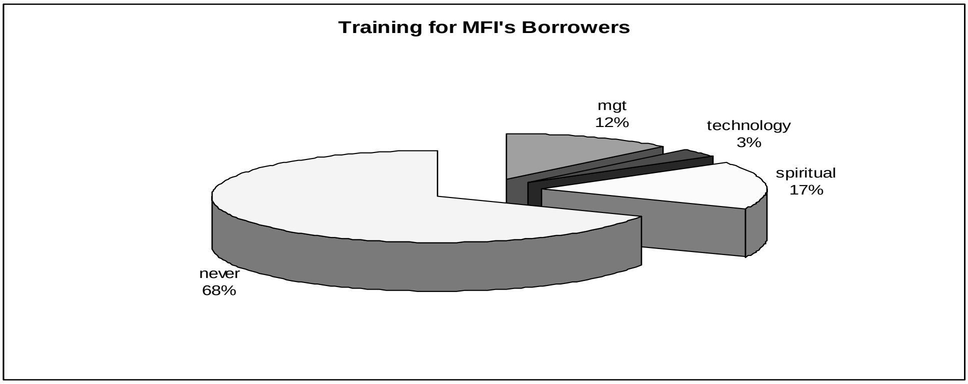
Lack of understanding about Islamic microfinance products can be partly understood by considering the training sessions that the clients had received. This is shown in Table 10.

Table-10
Training per MFI's Type

		Training	No Training	
MFI's Clients	BMT	60	47	107
	BPR	13	130	143
	BPRS	42	81	123
	BRI	66	142	208
Total		181 (31.15%)	400 (68.85%)	581

The survey shows that the majority of the clients in the sample did not receive training during the loan periods (68.85%). Table 10 shows that only 31.15% of MFI clients received training sessions and only a small number of them from BRI, BPR and BPRS received these sessions. However, the majority of BMT's clients received training (56%). For those who received training, only 17% clients received spiritual training, 12% and 3% received management and technological training respectively (see Figure 5 below).

Figure-5
Training for MFI's Clients



There was no specific training on the introduction of microfinance products provided by Islamic MFIs. This probably explains the overall lack of understanding on Islamic products among the clients of MFIs.

5.3. Clients' Perception to their Relative Interest Paid

Table 8 above showed the monthly average interest rate/mark-up/return rate that clients of different MFIs pay. The table indicates that BRI on average had the lowest interest rate, respectively followed by BPRS, BMT and BPR. Interestingly, when clients were asked about their perceptions about the interest rate/rate of return they pay compared to other MFIs, 48.4% clients felt that the rate of his/her MFI was equal to other MFIs, and only 5.3% said that his/her rate was higher than others (see Table 11 below).

Table-11
Perception of Relative Interest Rate Paid per Different MFI

		Perception of Relative interest rate compared to other MFI's			
		lower	equal	higher	Total
MFI's Clients	BMT	72	29	6	107
	BPR	28	101	14	143
	BPRS	45	73	5	123
	BRI	124	78	6	208
Total		269 (46.3%)	281 (48.4%)	31 (5.3%)	581

Table 11 shows that even though BPR had the highest interest/profit rate (as shown in Table 8), majority of its clients perceived the interest rate to be equal to other MFIs. Akin to BPR, BPRS clients demonstrated the same perception but actually the fact was quite higher than BRI. Surprisingly, most BMT clients perceived that BMT's rate was lower than other MFIs (67.3%). Whereas in the reality, BMT's rate were quite high compared to BRI and BPRS. The majority of BRI's clients said that BRI's rate was reasonable and relatively lower than other which was in line with the results in Table 8.

5.4. Clients Preferences for Conventional or Islamic MFI

Table 12 shows that 54.4% of respondents preferred an Islamic MFI to a conventional MFI (45.6%). When asked about the reasons behind this, most clients answered that using Islamic products as Muslims was harmonious with their belief and gave them peace and confidence. It is interesting to see a significant number of people using conventional MFIs also indicate their preference for Islamic finance. Despite this, they use conventional MFIs due to practicality and economic factors. Reasons of choosing different MFIs are discussed in the next section (Table 13).

Table-12
Preferences of MFI's Clients

		Prefer Islamic MFI		
		No	Yes	Total
MFI's Clients	BMT	1 (1%)	106 (99%)	107
	BPR	116 (81.1%)	27 (18.9%)	143
	BPRS	35 (28.5%)	88 (71.5%)	123
	BRI	113 (54.3%)	95 (45.6%)	208
Total		265 (45.6%)	316 (54.4%)	581

It was reasonable if 99% of BMT's (Islamic MFI) clients preferred to choose Islamic MFI and also made sense if 81.1% of BPR (conventional MFI) clients preferred conventional MFI. However, the fact that there were 28.5% of BPRS and 1% of BMT (both Islamic MFIs) clients who preferred conventional MFI seems puzzling. This is also the case for 45.6% of BRI and 18.9% of BPR clients who preferred Islamic MFIs rather than conventional MFIs, but using these MFIs although they were aware that these were conventional MFIs. Moreover, the proportion of BRI clients who preferred Islamic MFI and those who preferred conventional was almost equal. These findings of preferring one thing and choosing another appear to indicate inconsistent behavior. The next sub-section attempts to answer some of the reasons for this.

5.5. The Reason of Clients in Choosing a MFI

In order to understand the reasons behind their decision to choose a MFI, the clients were asked to rank the MFIs based on economic and non-economic factors. Based on the literature on microfinance and the preliminary research in the fieldwork, there are five non-economic factors mainly related to services. These include location (nearness), easiness, speed/promptness, profile of loan officers (LO) and payment method. The three economic factors are identified as low collateral, size of loan, and low interest/cost of fund. They were also asked to rank these factors according to their priorities.

Table-13
Reasons in choosing a MFI

Ranking of Clients' Reasons to Choose a MFI								
Services					Economy/Finance			Ranking /Priority
Nearness	Easiness	Speed	Loan Officer	Payment Method	Loan Size	Low Collateral	Low Interest	
66	(1) 316	63	7	10	15	15	108	1
117	132	(2) 173	9	8	16	26	109	2
96	72	151	20	12	21	32	(3) 178	3
(4) 140	29	138	22	46	39	83	83	4
33	6	27	31	54	99	(5) 268	57	5
26	9	14	71	111	(6) 241	82	19	6
27	10	10	109	(7) 280	73	48	17	7
76	7	5	(8) 312	60	77	27	10	8
Total 581	581	581	581	581	581	581	581	

Table 13 above shows that easiness in processes was the first priority for 316 out of 581 clients when selecting a MFI, followed by speed/promptness (fast) of the application process, low interest rate, nearness, low collateral, size of loan, payment methods and profile of loan officer which came second, third and up to eight respectively. The low interest rate/mark-up margin rate became the third priority for clients after easiness and speed/fast in the application process. Some non-economic factors, mostly related to services, such as ease, speed in the process and nearness to the market were prioritized high by clients compared to economic factors such as low interest, low collateral and size of loan. In many interviews, the surveyor got the impression that rational choice in terms of management issues and economic factors were the main reasons for selecting an MFI and religious reasons came subsequently.

The findings present some interesting implications in understanding the behavior of Indonesian Muslim clients towards economic transactions and spiritual aspects. Where when respondents were asked about their preferences towards their choice for Islamic products or conventional, the majority preferred Islamic MFIs. However, in reality their economic choices appear to be based on the economic and non-economic factors which become dominant in clients' decision to choose a MFI.

5.5.1. MFI's Clients Rankings

Respondents were also asked to rank MFIs based on the services and economy/finance categories. MFIs in Bandung face fierce competition because clients have opportunities to choose a MFI that suits his/her needs. Therefore, the majority of them are well acquainted with the reputations of other MFIs and their operations. The clients are able to compare between the different MFIs before deciding on choosing a particular MFI.

Table-14
Ranking of MFIs based on MFI's Clients Perspectives

	BPR	BPRS	BMT	BRI
Sharīʿah compliant	4	2	1	3
Easy	2	3	4	1
Application process	3	2	4	1
Low Interest	4	2	3	1
Speed/Fast	2	1	4	3
Low Collateral	4	3	2	1
Payment Methods	3	2	4	1
Loan's Officers	3	2	4	1
Preference	3	2	4	1
Overall	3	2	4	1

Table 14 shows the rating for each MFI from 581 respondents' perspectives. The results reveal that the clients rank BMT highest for Sharīʿah compliance and BPRS for speed/fastness in process application. For all other categories BRI gets the highest rank. Specifically, BRI was well known to have good services related to easiness, good process of application, low interest rates, low collateral, appropriate payment methods, excellent relationship with loan officer categories. Given these features, BRI was also ranked highest in the overall category and can be considered as the most preferable MFI.

6. Conclusions

Based on information gathered from a survey of four MFIs in Indonesia, it can be concluded that BRI, a conventional MFI, is preferred by the clients most. The empirical data clearly show that disparity in the growth of BRI, BPR, BPRS and BMT can be explained partly by many economic and non-economic factors. Although most of clients were Muslims and indicate preference for Islamic MFIs, in reality their choices of MFI were based on economic (low interest rates, low collateral and size of loan) and non-economic factors (such as quality of services variables; easiness, speed/fast, nearness, payment method and loan officers' profile).

There appears to inconsistency in the behavior whereas conventional MFI's clients preferred an Islamic MFI and Islamic MFI's clients preferred a conventional MFI. Dealing with these issues is not an easy task. Their unconscious (or conscious) loyalty is towards the moral/ethical teachings of Islam and the economic reality seem to conflict with each other. Prohibition of *ribā* has not made any significant impact on some of the clients' behavior yet. The findings in this paper imply that in order to attract clients to use Islamic microfinance the Islamic MFIs have to provide the same level and quality of products and services as the conventional ones.

BRI as a state-owned bank has a robust structure, special privilege from government, long experience, cheaper source of funds and scale of economies makes it a strong institution and the primary source of loan for clients. Moreover, the MFIs include in this study inevitably must also compete with large commercial banks which have widely opened micro-banking units to reach micro-entrepreneurs and also other forms of non-bank financial institutions such as pegadaian/rahn/pawnshop, SHG (self-help group), Credit Union (CU), and *Koperasi Simpan Pinjam*/*KSP* (savings and credit cooperative) which have operated in surrounding residential areas. As long as the existing banking regulations do not change to level the playing field, it will be difficult for BPR, BPRS, and BMT to compete and grow significantly in the future.

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