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"Building Islamic Ethics into Development: Exploring the Role and Limitations of 'Islamic' Microfinance in Poverty Alleviation. An Indonesian Case Study"

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1. Introduction

IBF (Islamic banking and finance) has been described as no more than a collection of Islamic terms and labels to facilitate the marketing of global finance products to Muslim communities and to further their structural dependency. In terms of development, this implies IBF has failed to promote human welfare, protect the environment and facilitate the autonomy of Muslim communities. Rather, critics, such as Tariq Ramadan, claim that aspects of IBF have perpetuated cycles of over-consumption, production and waste, while bonding Muslims into a lifetime of debt and consumerism.

Taking a religious socio-legal perspective, our paper challenges this critique with a re-appraisal of Islamic ethics in the developmental context and a focus on Islamic microfinance that deals directly with poverty alleviation. We examine a case study of different Islamic microfinance institutional models in the Indonesian context. The research examines their structures and practical operations in local communities working within Shari'a frameworks. Although far from perfect, we argue Islamic microfinance exhibits the very ethical values Ramadan demands but needs further reforms to more closely align with the higher objectives of the Shari'a (*al-maqasid*) and principles of excellence (*al-Ihsan*).

The paper is divided into five parts. Part 1 examines the ethical problems actual and perceived with banking and Islamic banking, focusing on the Ramadan challenge. Part 2 sets out and explains Islamic ethics in the development context. Part 3 introduces Islamic microfinance as an example of Islamic ethics in practice. Part 4 evaluates Islamic microfinance through an Indonesian case study and Part 5 re-visits the Ramadan critique. In the conclusion, we broaden the discussion and make more generalised statements in the contexts of Islamic ethics and development.

2. The ethical problem with banking and Islamic banking

According to Tariq Ramadan, philosopher and Oxford academic, 'development', from an Islamic perspective, means more than achieving quantifiable levels of economic growth, or even lifting communities out of material poverty. It requires challenging the very motivations and mentalities that make us work; changing the values of a consumption-driven capitalist society and replacing them with genuine Islamic values so as to forge an economic system founded on justice and ethics. For him, the important point is 'to associate ethical conscience with economic action, its source and origin, to question its goals, intentions and priorities.'

The Islamic banking and finance (IBF) industry has been in operation for more than half a century and has purported to fill an ethical gap in the mainstream, with mechanisms of finance purportedly avoiding interest and exploitation, while emphasising transparency and mutuality. Through the Islamic Development Bank (IsDB), a regional development bank for the Islamic world, specifically IBF has also attempted to address the needs of marginalised and impoverished communities through financing infrastructure, social programs and various Islamic microfinance projects. Beyond the IsDB, state bodies and non-state actors across the Muslim world, have also set up their own financial institutions and houses with their stated 'higher objectives' of improving human welfare beyond just material and economic improvement per se.

The problem for Tariq Ramadan, and similar critics,[1] is that these bodies, through notions of Shari'a compliance and 'Islamic windows' especially, have merely opened up another market for the conventional global bankers and financiers. Far from challenging the status quo, these 'Islamic' bodies, he wrote (a decade ago), have been only 'Islamizing the means…while legitimating an unethical capitalism interested only in end results… an Islamized Americanization under a coat of very halal terminology and financial techniques.'[2] The form may be Islamic, technically complying with the pre-requisites (*shurut*) and conditions (*arkan*) of a particular (classical) contractual template found in the handbooks of Islamic law (the *fiqh*). But in substance, the 'debt bondage' between the financier and the customer is the same in the 'Islamic' as in the 'conventional'. In fact, he argues, the so-called 'Islamic' is much worse as it preys on the vulnerable, religiously sanctifies the oppression, and charges a higher premium for the 'privilege'. 'The lawful character of the means,' he writes, 'can never justify the foreseeable immorality of the ends.'[3] He goes as far as to endorse the notion the industry is 'fraudulent'.[4]

Ramadan's critique is powerful and structural; it goes beyond firing pot-shots at the IBF industry. In short, he argues that IBF, no matter how you re-package it, cannot but help to

[1] See Mahmoud El-Gamal, et al.
[2] Tariq Ramadan, 2008. *Radical Reform: Islamic Ethics and Liberation'*, OUP, Oxford, p. 252.
[3] Ibid, at p 24.
[4] See further his interview with David Musa Pidcock, CILE 2014: https://www.cilecenter.org/media-center/videos-webtv/tariq-ramadan-and-david-musa-pidcock-islamic-banking, accessed 14 November 2019.

reproduce the same forces, dynamics and results as conventional banking and finance as it shares the very same ideology, financial architecture and even personnel. Whether wholesale or retail banking, bonds or securities, insurance or microfinance, he says the Islamic sector follows the same ideological paradigm and path as the conventional – the 'ethics of profit and consumption' and an aversion to risk. Expressed in these structural terms, Ramadan's argument represents a theoretical and ideological challenge to the very existence of IBF in general, including its operations in Islamic microfinance. From this perspective, the prospects of building 'Islamic' ethics into development and the implications for economic and social development in the Muslim world are not promising.

The essential weakness of Ramadan's thesis is that it is built on general observations and a one-sided perception of an industry that has deliberately sought change through evolution rather than revolution, and integration rather than through separation. There is no radical restructuring of the economic system because that is beyond the capacity of the IBF industry. Rather, the IBF industry makes incremental changes and improvements to give Muslims a 'halal' alternative, albeit one that falls short of the Islamic ideal. This is with a view to building momentum and increasing its share in the economy until it achieves a dominant position and is better able to bring about the value-based reforms Ramadan so eloquently proposes. Indeed, 'value-based intermediation' (VBI) in which Islamic banks emphasise not just Shari'a-compliance and profit but also positive contributions to the economy, community and environment in line with the 'Maqasid al-Shari'a' (the higher objectives of the Shari'a), are now the preferred paradigm for Islamic banks in Malaysia.[5] With government support and led by the Central Bank, a harmonised system of national regulation and integration through the state's central bank has produced positive benefits.[6] According to recent studies, we are also witnessing the economic benefits of similar approaches to IBF also in the United Arab Emirates.[7]

A second fundamental weakness of the Ramadan thesis is that it is a 'top-down' and general theory, with little empirical foundation and scant analysis of the variety of IBF enterprises

[5] See: Nor Shamsiah Mohd Yunus, Governor of the Central Bank of Malaysia, keynote address to the Global Islamic Finance Forum 2018, 3 October 2018: https://www.bis.org/review/r181003e.pdf; accessed on 14 November 2019.

[6] Salina Kassim, 2016. Islamic finance and economic growth: the Malaysian experience. *Global Finance Journal* 30: 66–76.

[7] See: Baaeth Atallah Aldalaien, 2019. The Impact of Islamic Banks on the Gross Domestic Product (GDP): An Empirical Study in Dubai International. *Journal of Business and Management*; Vol. 14, No. 4.

across the Muslim world. His argument pays little attention to those sectors of IBF, such as Islamic microfinance for example, that have focused on development, on a more holistic approach to human welfare, establishing enterprises within local communities set up to serve the latter rather than to boost the profits of the big businesses, sovereign wealth funds or high net-worth individuals.

Notwithstanding these criticisms, Ramadan still has a point. The conventional finance industry also has sectors that promotes charity and social welfare, but its fundamental characteristics remain the same because of its orientating ideology and structure. Moreover, while Islamic microfinance may have roots in the community and have noble aspirations, it begs the question whether they are in fact exploiting the Muslim poor rather than serving them. Both assertions are empirical questions which this paper seeks, in part, to explore through our qualitative study in Part 3.

The purpose of this study, challenged by Ramadan's critique of IBF, is to examine the role and potential of Islamic ethics, as well as the extent to which it can be realised in producing beneficial development outcomes for Muslim communities. This exploration begins by setting out its broad substantive framework in the following Part 2.

3. Islamic Ethics

Islamic ethics (*akhlaqiyyat Islamiyyah*) provide a framework to guide the law's implementation and ensure compliance with '*Ihsan*' (the worship of Allah, *as if* you see Him), through the pursuit of Islam's 'higher objectives' (*al-maqasid*). This is what we use to assess Islamic banking and finance (IBF) and particularly, Islamic microfinance. Islamic ethics have core and subsidiary elements. The core or essential Islamic ethic is the right conduct informed by the belief in *Al-Tawhid* or 'Oneness' – that God has no partner in His Divinity and is the One, True Owner of the Universe and everything that is in it. What we have is but a trust from God: from looking after our own bodies, and expenditure on our families and in our communities to caring for the environment. Both the Qur'an and the Hadith refer to human beings, normatively, as both trustees ('*khala'if*') and stewards ('*ra'oon*'), implying this is not our world to do as we like, to acquire, spend and consume as we wish, but to follow the limits which God has set in all our actions. The Qur'an mentions: 'Believe in Allah and His Messenger and spend of that whereof He hath made you *trustees* (*mustakhlifeen*); and such of you as believe and spend (aright), theirs will be a great reward.'[8] This applies in all aspects of interpersonal human relations and is a responsibility shared by *all* of humanity, for Prophet Muhammad stated: 'Every one of you is a steward and is responsible for his charges: the Ruler of the people is a steward and is responsible for his subjects; a man is the steward of his household and is responsible for it; a woman is the steward of her husband's home and is responsible for it; and the servant of a man is a steward of his master's property and is responsible for it. All of you is a steward and is responsible for his charges.'[9] As trustees and stewards, we are each responsible for bringing about the conditions for, maintaining and preserving human welfare. From an Islamic perspective, bearing and taking charge of that responsibility should be intentional and purposive; namely, an act of worship ('*ibadah*). If IBF is to be purposive, therefore, it must connect back to a Qur'anic worldview that sees the human as Allah's Trustees on Earth.

Beneath this core ethic of right conduct under a Divine Trust, lie the subsidiary ethics of legality and justice, in the form of the Shari'a (the Divine Law or Path). Unlike western notions of ethics which frequently divorce 'law' or the legal from the ethical or moral (legal positivism is founded on that distinction). The Islamic notion of 'legal' is an essential part, indeed the foundation, of Islam's 'ethical'. Islamic ethics are first and foremost grounded in compliance with Divine commands ('Say (O Muhammad): Obey Allah and His Messenger').[10] So, when Allah says in the Qur'an that He prohibited *riba* (unlawful gain/interest)[11], and threatened with severe punishment the one who receives, pays, drafts and witnesses the contracts that contain it[12], it is both unlawful (*haram*) and fundamentally unethical to deal in it. There can be no greater unethical act than to disobey one's Creator. Conversely, the systematic and purposive efforts to avoid disobeying Allah and to remove *riba* from all financial dealings (the primary objective of the IBF industry, including Islamic microfinance), are necessarily ethical acts and receive Divine compensation.[13]

And yet, the Shari'a is also not just a legal treatise, and certainly not in the way that a civil or a common law lawyer would understand it. It is not just a list of 'dos' (*al-wajibat*) and 'don'ts' (*al-muharramat*). Rather, it represents a comprehensive code, informing humankind also what

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[8] Qur'an, *Surah al-Hadid,* verse 7.
[9] Ibn Abi Jamrat al-Azdi, 'Abdullah ibn Sa'd. 1993. *Mukhtasar Sahih al-Bukhari*. Beirut: Dar Ibn al-Hazm, Kitab al-Jumu'at, Hadith No 51, at p. 50.
[10] Qur'an, *Surah Aal 'Imran*, verse 32.
[11] Qur'an, *Surah al-Baqarah,* verse 275.
[12] Sahih Muslim, Hadith no. 1598.
[13] Imam al-Juwayni, *al-Waraqat*, at p.1.

it *ought* or is best to avoid (*al-makruhat*) and what it best or *ought* to do (*al-mandubat*). The code also embeds 'higher objectives' (*al-maqasid*), with each ruling, as Al-Ghazali mentioned, having a wisdom behind it. Traditionally, scholars listed five higher objectives in terms of the protection of religion, life, faculty of reason, progeny and property. In fact, the higher objectives of the Shari'a go much further than *protecting* or *preserving* these 'five essentials'.[14] Indeed, they also enhance and help to refine human behaviour with a view to achieving a state of perfection/excellence or '*al-ihsan'* and, ultimately, a 'just' and 'developed' society.

To achieve that state of perfection, or to even begin that journey, requires prioritisation. First among priorities is to repel harm (through preventing and removing the unlawful and facilitating the obligatory) – what al-Shatibi referred to as the '*'ad-daruriyyat*" (the essentials). Second, is to fulfil needs – "*al-hajjat*", and third is to provide embellishments or refinements – "*at-tahseeniyyat*". Much of the problem, in a practical sense and in the contemporary world, is determining where a particular behaviour, act or request, sits on that scale, and whether there are 'absolutes', including indicators of poverty, for example.

And yet behind these efforts, must lie personal commitment, benevolence and sensitivity. Habib Ali al-Jifri writes: 'The Prophet (may Allah raise his rank and grant him peace) also invested money in the development of the individual. He would spend any funds he received, whether they were private or public, to fulfil the needs of individuals and society. He never saved any money.'[15] It necessarily follows that effective and ethical development, from an Islamic perspective, are committed and benevolent initiatives and cannot just be 'rule-based' or formalistic. They must be grounded in benevolence, operated by committed individuals, and responsive to the reality of need on the ground (*al-waqi'a*). What we gain from personal commitment is a constant struggle (*jihad*) about motivations and intentions and it is for IBF stakeholders to critically reflect their actions accordingly (*tafakkur*) and constantly prepare to renew their intentions towards the earth and their fellow humanity.

4. Islamic microfinance

Islamic microfinance presents the confluence of microfinance and the Islamic banking and finance (IBF) worlds. Microfinance is the provision of financial services to marginalised

[14] A number of scholars, Ahmad al-Raysuni and Tariq Ramadan among them, have elaborated much further and expanded on these five.
[15] Habib Ali al-Jifri, 2019. Humanity Before Religiosity: Dar al-Faqih, UAE, p. 140.

population segments and is widely considered a major tool to alleviate poverty, empower women and facilitate economic development. Microfinance addresses market failure, in the sense that traditional banks do not consider the poor to be "bankable" due to lack of collateral and credit histories. As a result, the poor often resort to moneylenders, savings clubs, rotating savings and credit associations (ROSCAs) and mutual savings societies (e.g., rice clubs) which are insecure, risky, inefficient and costly. Originating with the provision of small-value loans to the non-banked poor, microfinance now incorporates a range of services including payments, savings and insurance.

Islamic microfinance shares with conventional microfinance the principles that advocate entrepreneurship, risk-sharing and belief that the poor should take ownership of their livelihood rather than depend on hand-outs.[16] Chapra has acknowledged that access to finance is also necessary to realise the egalitarian objectives of Islam in terms of opportunity and that business ownership helps one attain a sense of "independence, dignity and self-respect".[17] Where Islamic microfinance differs is in the use of alternative contracts that attempt to avoid the twin *Shari'a* prohibitions of *riba* and *gharar*.[18]

In Muslim-majority communities, studies have noted substantial demand for Islamic microfinance, which is preferred over conventional financial services.[19] Forty-nine per cent

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[16] (Dhumale and Sapcanin, 1999)
[17] (Chapra, 1992: 269)
[18] M. A. Uddin, *Principles of Islamic Finance: Prohibition of Riba, Gharar and Maysir*, International Centre for Education in Islamic Finance, Kuala Lumpur, Malaysia, (2015), available at: <https://mpra.ub.uni-muenchen.de/67711/1/MPRA_paper_67711.pdf>, accessed March 5, 2017. For a detailed overview of Islamic microfinance, see, M. Obaidullah, *Introduction to Islamic Microfinance*, IBF Net Limited (2008), available at: <https://ssrn.com/abstract=1506072>, accessed October 14, 2016. *Riba*, or unlawful gain, is a restriction on one party obtaining a higher payoff compared to the other in bilateral contracts without any association with real economic activity, based on an asset of value. It is commonly translated as interest payments which are guaranteed payments that the borrower must pay to the lender with no regard to a physical asset. *Gharar*, is loosely defined as unreasonable uncertainty where there is potential for one party to exploit the other party in terms of limited experience or "chance" outcomes.
[19] Surveys commissioned by the International Finance Corporation (IFC) and Frankfurt School of Finance and Management found that 20% of the poor cite religious reasons for not utilising conventional microfinance in Jordan and Algeria. This proportion rises to 40% in Yemen and Syria. Also, a 2008 Consultative Group to Assist the Poor study found similar demand trends in Indonesia, Afghanistan, Pakistan, and the Palestinian territories, and also in the Muslim majority areas of India, Sri Lanka, Cambodia, and the Philippines. Finally, a Bank Indonesia report found 49% of the rural poor in 2000 considered interest non-compliant with *Sharia* and preferred to bank with Islamic financial institutions. See IFC and FINCA, *Business Plan for a Microfinance Institution in Jordan,* Frankfurt School of Finance and Management (Bankakademie International, 2006), IFC and FINCA, *Access to Finance Study in Algeria, Final Report* (Frankfurt: Frankfurt School of Finance and Management, 2016), IFC, *Assessment of MSE Financial Needs in Yemen Final Report* (Washington, D.C.: IFC/The World Bank, December 2007a), IFC. *Syria Microfinance Market Assessment* (Draft Report, Washington, D.C.: IFC/The World Bank, November 2007b), and N. Karim and M. Khaled, *Taking Islamic Microfinance to Scale*, Consultative Group

(49%) of rural households in East Java, for example, would prefer to bank with Islamic than conventional financial institutions to avoid interest.[20] This demonstrates immense untapped potential for financial inclusion and poverty alleviation, especially where Muslim countries feature large unbanked populations.[21] Specifically, panel data evidence in Indonesia has shown that microcredit can assist in reducing poverty levels.[22] Although there is widespread scepticism about the extent of its impact on poverty reduction in the short term, it is generally accepted that microfinance has helped the poor to smooth consumption over cyclical downturns or unexpected crises.[23] In relation to Indonesia, Pitt and Rosenzweig[24] have observed that, at least in the short term, microfinance services has helped short-term increases in the consumption of fish, fruit or vegetables by ten per cent. This in turn, has reduced the chances of illness by nine, three and six per cent, respectively.

4.1 A structural overview of Islamic microfinance in Indonesia

While arguably some variation of Islamic financing has existed since Islam gained a foothold In Indonesia in the 13th century, formal institutions began in the 1980s with the establishment of Bait At-Tamwil Salman ITB in Bandung and the Ridho Gusti Cooperative in Jakarta. Fianto and Gan explain that Islamic MFIs pioneered the establishment of the IBF sector through their early experiments and widespread adoption via community awareness-raising. Indonesia now has one of the most diverse and deep microfinance sectors in the world.[25] There are approximately six thousand formal and forty eight thousand semi-formal registered microcredit units that have forty five million depositors and thirty two million borrowers; eight hundred thousand channelling groups and millions of informal financial institutions and self-help

to Assist the Poor (2011), available at: <http://www.cgap.org/blog/taking-islamic-microfinance-scale>, accessed August 2, 2017.

[20] (OJK, 2015a; Karim *et al*., 2008; Seibel & Dwi Agung, 2006)

[21] L. Klapper and S. Ansar, *Can Islamic finance boost financial inclusion?* (Brookings Institute, June 8, 2017), available at: <https://www.brookings.edu/blog/future-development/2017/06/08/can-islamic-finance-boost-financial-inclusion>, accessed August 5, 2017.

14. Suryahadi, A., Hadiwidjaja, G. and Sumarto, S., 'Economic Growth and Poverty Reduction in Indonesia Before and After the Asian Financial Crisis', *Bulletin of Indonesian Economic Studies, 48 (2),* 2012, p. 209–27.

15. Chowdhury, A., 'Microfinance as Poverty Reduction Tool – A Critical Assessment', DEA Working Paper No. 89, United Nations Department of Economic and Social Affairs, New York, 2009; Cizakca, M., 'Cash Waqfs of Bursa, 1555–1823', *Journal of Economic and Social History of the Orient, 38 (3)*, 1995, pp. 313–54.

16. *Pitt, M.M. and Rosenzweig, M.R., 'Health and Nutrient Consumption Across and Within Farm Households', Review of Economics and Statistics, 67 (2), 1985, pp. 212–23.*

[25] Seibel & Dwi Agung, 2006.

groups.[26] Despite differences in the products and services provided, Islamic microfinance operates using similar models to conventional microfinance. Drawing upon the success of the Grameen Bank, Obaidullah explains that most Islamic microfinance institutions (IMFIs) utilise the group-borrower model that relies on group pressure as an alternative to collateral to mitigate individual default risk.[27]

The industry is structured along three tiers as follows: the most formal and well-established is *Bank Pembiayaan Rakyat Syariah (BPRS)* or the Islamic Rural Bank, then the smaller and less prominent *Lembaga Keuangan Mikro Syariah (LKMS)* or Islamic Microfinance Institution; and finally, the traditional and more informal institutions known as *Baitul Mal wa Tamwil (BMT)* or Islamic Cooperative. While the BPRS and LKMS[28] are regulated with other banks and major financial institutions by the *Otoritas Jasa Keuangan (OJK)* or Financial Services Authority, the BMT are supervised by the Ministry of Cooperatives and Small and Medium Enterprises (MoCSMEs), which tends to be less stringent. There are also numerous unregistered and informal BMTs that are not registered with the MoCSMEs. They are mainly affiliated with Indonesia's Islamic mass organizations who provide some limited supervision. The MoCSMEs records that there were 38,083 formal savings and loan cooperatives under its supervision in 2005.[29] It is also estimated that there were 4,117 formal Islamic financial cooperatives in 2012[30] out of a potential total of 40,000 cooperatives in 2005.[31]

While there are many associations and organisations that have a stake in Islamic microfinance and influence its development and implementation, arguably the most important is the Indonesian Ulama Council (DSN-MUI). The DSN-MUI is responsible for the *Shari'a* compliance of all Islamic financial institutions' products and services in Indonesia.[32] Like the BPRS, the BMT must have their own *Shari'a* board to ensure their products and services comply with *fatwa* guidance given by DSN-MUI, but this is not universally supervised by

[26] Seibel, Hans Dieter. "Islamic Microfinance in Indonesia: The Challenge of Institutional Diversity, Regulation and Supervision." *Journal of Social Issues in Southeast Asia* 23, no. 1 (2008): 86-10.

[27] Obaidullah (2008), *supra* note 53.
[28] As LKMS are a smaller version of BPRS, both types of institutions will be collectively referred to as BPRS
[29] (OJK, 2014a; MoCMSMEs Republic of Indonesia, 2005)
[30] (OJK, 2014a; Sugianto, 2012)
19. Bank Indonesia's Islamic Banking Department estimates that BMTs serve around 100,000 clients with assets of 1.4 trillion rupiah (US$145 million). El-Zoghbi, M. and Tarazi, M. 'Trends in Sharia-Compliant Financial Inclusion', *Focus Note* No. 84, Consultative Group to Assist the Poor, 2013.
20. Seibel, H.D., 'Islamic Microfinance in Indonesia: The Challenge of Institutional Diversity, Regulation, and Supervision', *Journal of Social Issues in Southeast Asia, 23 (1),* 2008, pp. 86–103
[32] (The Council of Indonesian Ulama, 2013)

MoCSME. Both the OJK and MoC collaborate with DSN-MUI to facilitate *Shari'a* training for Islamic MFI management and *Sharia* boards and have established a certification program, though it is currently being introduced in phases starting with the main economic centres in Jakarta and Surabaya.

4.2 Shari'a-compliant finance products

Islamic microfinance in Indonesia features the full suite of services as customers require both savings, financing and insurance solutions. As a result, both BPRS and BMT have adopted a range of standard IBF products.[33] BPRS portfolios are more limited as they operate largely as traditional banking institutions and face greater regulator supervision. The diversity of BMT structures and the fact that they operate with lower regulatory oversight allows them to experiment and offer a more diverse set of products to meet clients' needs. For instance, BMT Kube in Sulawesi Selatan use gold pawning (*rahn*) among the Bugis ethnic community who maintain large gold holdings.[34] The largest and most successful BMTs, such as BMT Bringharjo in Yogyakarta, the largest BMT in 2014 with twelve national branches, operate like fully fledged financial institutions, offering the greatest variety of loan products.

Standard Islamic microfinance products include *musharaka*, *mudharaba* or *bai' bi-thaman-il ajil*, *murabaha*, *ijarah* and a variation of *ijarah* (*ijarah wa iqtina*). This *ijarah* product provides an option of removal of ownership of the leased items from the bank by another party.[35] As is common across the global IBF industry, *murabaha*, a debt-based contract, comprises the largest share of BPRS and BMT financing.[36] Since BMTs target lower socio-economic segments, they typically also provide *qard hasan* (benevolent loan, re-payment of principal only) financing as well as direct grants.[37]

[33] See Appendix 1
[34] Wulandari et al. (2016); p. 239. BMT Kube has innovated to develop their *rahn* product such that it has fewer restrictions and regulations compared to a typical government pawnshop. However, BMT Kube has limited profit-and-loss sharing contracts because the poor in Sulawesi Selatan frequently change their businesses depending on the season such as selling meatballs in the rainy season and ice cream in the dry season. This makes it difficult to implement long-tenor loss-sharing contracts.
[35] Riwajanti and Asutay (2013); cited in Thaker & Thaker (2016), p. 4.
[36] Wulandari et al. (2016); p. 238
[37] Adnan and Adjija (2015), p. 163.

Despite considerable debate, profit-and-loss sharing, equity-based models, are generally held up as the "Islamic ideal" for conducting Islamic finance.[38] This is because they closely represent classical methods of transactions and are completely distinguishable from interest-bearing debt products with fixed returns.[39] Asutay (2007) argues that profit-and-loss contracts help achieve justice and equality and better meet the *maqasid*[40] we outlined above. However, in reality, Islamic financial institutions have tended to implement structured-financial models that replace loans and fixed-income securities to manage credit risk.[41] Writers like El-Gamal and Asutay[42] argue that IBF actors globally have mainly been using synthetic loan structures based on credit sales (*murabaha*) and leasing (*ijara*) that replicate conventional banks.[43] Farooq provides three reasons for the overwhelming utilisation of debt-based contracts.[44] First, profit-and-loss sharing contracts are vulnerable to the agency problem whereby clients are incentivised to report less profit and are disincentivised to apply effort beyond the earnings they require. Secondly, Islamic financial institutions must compete with conventional products in terms of pricing, customer experience and comprehension. Thirdly, profit-and-loss contracts do not meet the needs for short-term finance due to often customers need for immediate cash and their high degree of risk. Fianto and Gan also explain that profit-and-loss sharing contracts also bring a moral hazard problem where the entrepreneur may take on a higher risk project to gain profit but bear lower financial risk (in the case of *musharaka*) or no financial risk (in the case of *mudaraba*).[45]

The most types of financing schemes that are utilised by IMFIs in Indonesia have included the debt-based *murabaha* (cost plus mark-up), but they also include the equity financing contracts of *mudaraba* (trustee financing) and *musharaka* (equity participation). [46]

[38] El-Gamal, http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.416.9179&rep=rep1&type=pdf (p. 2)
[39] Dusuki and Abdullah, 2006
[40] Bayu Arie Fianto, Christopher Gan, Baiding Hu, Jamal Roudaki. "Equity Financing and Debt-Based Financing: Evidence from Islamic Microfinance Institutions in Indonesia." Pacific-Basin Finance Journal (2017). Published electronically 23 September 2017. doi:10.1016/j.pacfin.2017.09.010, at 40.
[41] El-Gamal, http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.416.9179&rep=rep1&type=pdf (p. 2)
[42] Asutay, M., 'Conceptualising and locating the social failure of Islamic Finance: aspirations of Islamic moral economy vs. the realities of Islamic finance', Asian and African Area Studies, 11 (2), 2012, pp. 93–113.
[43] Debt-based financing forms the vast majority of contracts in Indonesia (for example, *murabaha*) constituting 78–80 percent over 2008–14 and partnership-based contracts constituting between 12–13 percent of contracts over the same period.
[44] Farooq (2007)
[45] Fianto and Gan (2017)
[46] Fianto and Gan (2017) (p. 244).

4.3 Islamic MFI's additional services

While all types of MFIs provide a range of support services, such as market linkages and insurance, Islamic MFIs additionally infuse moral qualities in their delivery. They focus on superior customer service, humane treatment and aim to build solidarity and brotherhood among their members. In the case of family tragedy (such as death or severe disability), Islamic MFIs utilise separately managed charitable funds to support the deceased (e.g., out of *zakah* or *sadaqah*). The additional services of Islamic MFIs stem from core *Shari'a* principles. The first is the objective of Islamic MFIs to implement ethical principles such as care for one's neighbours and promotion of ethical conduct (*adab*). Secondly, Islamic MFIs cannot charge penalties or compound customer's arrears payments. This means that they tend to practice more compassionate collection practices and is a key element of *Shari'a*-based financing.

Islamic MFIs, especially the BMT, provide greater forms of social assistance (than conventional microfinance) because they have access to pools of *zakah* and *sadaqa* funding. Like conventional MFIs, Islamic MFIs also utilise formal mechanisms to assist borrowers in the face of tragedy through either self-administered insurance or partnerships with insurance providers. In such instances, beneficiaries and members are required to contribute premiums to formally obtain cover or to fund a specially designated "risk" fund as per the Shari'a principles of mutual solidarity (*ta'awun*).

In Indonesia, the provisions of social services vary between different Islamic MFIs and is affected by the type of entity and access to social funds, as well as the overall profitability of their operations. Compared to the BPRS and LKMS, the BMTs tend to offer greater extra financial services for two reasons. First, they are structured as the union of two separate entities – the "*baitul mal*" which collects and distributes *zakah* and *sadaqah*, and the "*tamwil*" which provides deposit and financing services. Second, their overt social objective and grassroots operations also facilitates greater engagement with and offer more compassion towards vulnerable borrowers. They have a vested interest in supporting the local community, to enhance repayments and to access more customers via maintaining general goodwill and trust in the community. With the holding of annual general meetings (AGMs) and closer relationships with grassroots customers, BMTs are also associated with greater communal enhancement. For instance, BMT Muda enhance community spirit through organising extra-curricular activities for members, celebrating religious occasions, and visiting sick members or those who have had a child recently. BMT staff and members term this "*ukhuwat*", or the growth of social bonds via brotherhood.

5. An Islamic Microfinance, Socio-Legal Case Study

5.1 Indonesia

Beyond being the world's largest Muslim country, IBF and IMF matter to Indonesia for two important reasons. First, there is considerable demand for *Shari'a*-compliant financing services with surveys affirming a strong preference over conventional institutions.[47] *Shari'a*-compliant banks appear to be more accessible and responsive to the needs of micro, small and medium-sized enterprises (MSMEs).[48] Secondly, *Shari'a*-compliant funds can help address the significant MSME funding shortfall. Indonesia has more than 50 million MSMEs, representing some 97 per cent of all enterprises that contributed at least 30 per cent of gross domestic product (GDP) in 2012. Yet, more than 90 per cent do not have access to regular bank financing. Microfinance, therefore, can expand significantly, especially where it already accounts for 70 per cent of Islamic lending in Indonesia.[49] Therefore, we can expect increased Islamic MFI activity in Indonesia in the coming years with potential to reduce poverty.

Indonesia also works as a useful case study on the practical application of Shari'a ethical principles due to both the prevalence and strength of mass Islamic organisations, such as Nahdlatul Ulama and the Muhammadiyah, as well as the top-down policy and regulatory support for Islamic microfinance from the current Indonesian government (via the President's *Komite Nasional Keuangan Syariah/* National Islamic Finance Committee[50] and the regulator programs.[51]) The KNKS is making the development of an Islamic economy the starting point for joint coordination with public and private institutions.

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[47] Karim, N., Tarazi, M. and Reille, X., 'Islamic Microfinance: An Emerging Market Niche', Focus Note No. 49, Consultative Group to Assist the Poor, 2008.
[48] More than half of total Islamic bank financing went to MSMEs in 2012.
[49] Permatasari, S., 'Microfinance Dominates Indonesian Shariah Loans: Islamic Finance', Bloomberg, 24 November 2010. http://www.bloomberg.com/news/articles/2010-11-24/microfinance-dominates-indonesian-Shariah-loans-islamic-finance,accessed 15 November 2015.
[50] Instituted by Presidential Regulation No. 91 of 2016.
[51] One of the major government motivations to promote the Islamic economy and Islamic finance is to appease prominent religious voices and constituents who are advocating for greater implementation of Shari'a in Indonesian society.

The focus on Islamic microfinance is supported by the government's overt promotion and regulation of Islamic banking and finance.[52] With the passing of Law No. 1 of 2013 on Microfinance Institutions, all MFIs, regardless of entity type, operate under a single regulatory framework for registration and supervision.[53] The MFI law provides a legal basis for all microfinance operations by establishing minimum standards.[54] The flagship Islamic MFI program is the OJK-administered *Bank Waqf Mikro* (Micro Waqf Bank) which provides direct funding to *pesantrens* (traditional Islamic schools). The *pesantrens* operate as a non-deposit taking LKMS to support financial access in rural areas at a small, affordable margin.

Examining the intent and scope of the government's support for Islamic microfinance, it is clear that the key objective is *economic* development via accelerated rural empowerment and financial inclusion. For a country where still one in ten people are below the national poverty rate,[55] programs to enhance livelihoods and income generation are valued highly. As further noted by Bank Indonesia, the key focus in supporting Islamic banking is 'to provide the highest benefits to the public and to give optimal contribution to the national economy'.[56] This along with KNKS' stated objective to 'advance the development of Islamic finance in order to support national economic development,'[57] demonstrates the government's narrow focus towards preservation of wealth and material progress as opposed to the more holistic social development we out-lined above. The government's focus is to provide the initial impetus for the Islamic finance sector while leaving social and spiritual objectives to Islamic organisations and community associations.

[52] This goes back to its Blueprint on Islamic Banking and Finance in 2002; see Tim Lindsey, 2012. Regulation of Islamic Banking in Indonesia. Sydney Law Review: Vol 34: 107 at 121.

[53] A microfinance institution is defined in the legislation as 'a financial institution specially formed to provide services of business development and people empowerment, either by means of loans or financing of micro-scale business to its members and the people, loan management, or the provision of consultation services for business development which does not merely seek benefits' (Article 1(1)).

[54] The law addresses microfinance providers' legal form and ownership structure, eligibility to participate in micro-financing, scope of operations and deposit protection. It is not uncommon for institutions providing microcredit services to have multiple regulatory heads because the Law on Microfinance Institutions allows microfinance institutions to be formed as either cooperatives or limited liability companies (Article 5(1)). For example, BMTs are cooperatives that are supervised by the Ministry of Cooperatives and Small and Medium Enterprises but also microfinance institutions that are supervised by the OJK.

[55] https://www.thejakartapost.com/academia/2019/08/20/its-okay-to-be-poor-why-fighting-poverty-remains-challenging-in-indonesia.html, accessed 14 November 2019.

[56] https://www.bi.go.id/en/perbankan/syariah/Contents/Default.aspx accessed 12 November 2019.

[57] https://knks.go.id/about accessed 12 November 2019.

5.2 Methodology

While much literature on Islamic microfinance in Indonesia and beyond examines their operations, rationale and success in poverty alleviation, the motivations and perspectives of staff and beneficiaries is less understood and potentially can help shed light on the *operational values* and behaviours of IMFs in Indonesia and cut through the IBF industry's own propaganda and self-promotion. In contemporary, legally-pluralistic societies such as Indonesia, religious and customary law (*adat*) not only influence institutional behaviour but also operations and areas where state law has little reach – especially the remote towns. As a socio-legal inquiry, our research explores the relationship between legal and social factors in Islamic microfinance. Variously defined, the core of socio-legal studies is to take a multidisciplinary study of law and legal institutions to help bridge the "gap" between what may be called "law in the books" and what is applied in society as "law in action".[58]

Except in limited contexts, Islamic law is not applied wholesale as a state-enforced set of norms and rules. Many aspects of Islamic law coexist with state and other non-state rules and norms (i.e., "legal pluralism").[59] Where state or official law is divorced from social reality, unofficial or customary laws gain greater strength.[60] Thus, to effectively understand how Islamic law influences poverty alleviation programs, it is necessary to make observations of the implementation of Islamic norms and rules "in action".

It is widely understood that due to the existence of a large unbanked Muslim population, there is considerable latent demand for Islamic microfinance services.[61] However, when and why individuals take up or prefer Islamic microfinance when conventional microfinance services are available is less understood. While the expected practical rationales for the uptake of Islamic microfinance, such as lower borrowing costs and access, have been identified in previous literature,[62] we wished to explore the extent to which Islamic microfinance staff and

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[58] Menkel-Meadow, Carrie (1990), 'Durkheimian Epiphanies: The Importance of Engaged Social Science in Legal Studies,' Fla. St. L. Rev. 18: 91-119.

[59] Merry, Sally (1988) 'Legal Pluralism,' *Law & Society Rev.* 22: 869-896.

[60] (Yilmaz, 2000: 357)

[61] Fianto and Gan, 2017.

[62] Masyita, Dian and Ahmed, Habib. 'Why is Growth of Islamic Microfinance Lower than its Conventional Counterparts in Indonesia', *Islamic Economic Studies*. 21(1): 35-62.

borrowers' *experiences* have lived up to their expectations. By exploring any gaps between *Shari'a* rules and principles and the law on the ground, we hoped to investigate how Islamic microfinance institution staff apply Islamic rules and norms when implementing programs. Operating within the market for microfinance services, both staff and borrowers must make trade-offs when reconciling their religious obligations with day-to-day pragmatic requirements. Therefore, through an examination of the socio-legal dynamics of Islamic microfinance, our field research hoped to fill the lacunae in the existing literature and explain how the *Shari'a*, in its holistic sense, influenced poverty alleviation activities on the ground.

We conducted one-on-one deep interviews with Islamic microfinance beneficiaries, field staff, management and industry stakeholders. Two distinct types of Islamic MFIs were selected in East Java, based around the capital, Surabaya. The first was BMT Muda, a small-scale cooperative, and the second was a BPRS, Mitra Syariah, a rural bank with several local branches.

5.3 Evidence of an ethical Islamic framework for development

Islamic microfinance in Indonesia is achieving far more beneficial outcomes for beneficiaries than just enabling them to comply with their religious beliefs. This stems fundamentally from the purpose-led strategy and operational objectives of Islamic MFIs. They exist to reduce poverty among their members and their communities. Beyond their religious affiliations and identity, Islamic MFIs have deepened their reputation as a more just and humane institution compared with the formal banks, conventional MFIs and scrupulous money lenders.

5.4 Financing contracts and *Shari'a* methodology (*usul*)

In the short term, the clear objective of Shari'a authorities, such as DSN-MUI, Shari'a boards and regulators has been to "halalify" transactions that consumers are already undertaking. This is consistent with the general integrative approach of the IBF industry – to re-purpose classical Islamic contracts for modern applications. The borrowers in East Java typically obtain loans from moneylenders and conventional financial institutions to obtain funding for their businesses, to meet unexpected expenses or to invest in assets. As these are often based on survival and emergency needs, borrowers will seek out the most convenient funding source, even if it is not compliant with their religious tenets and which is often expensive and exploitative. To improve the marketability of Islamic microfinance, prevent fraudulent services and ensure compliance with religious tenets, government regulations require that Islamic MFIs have a certified *Shari'a* board. Certification is obtained through an examination and training conducted by DSN-MUI. Thereafter, the minimum obligation is to ensure that the Islamic MFIs utilise approved contracts in their deposit-taking and financing services. While OJK can ensure stricter compliance with Shari'a board certification, many BMTs continue to operate without certification because the MoCSMEs has limited supervisory capabilities and resources.

As Islamic microfinance takes product development cues and specialist knowledge from the general IBF sector, it is unsurprising that all of the common financing contracts are utilised, and debt-based contracts figure highly. However, the practice varies depending on the specific demographics of customers and the operational model of the Islamic MFI. As a regulated rural bank with a greater profit motive, BPRS tend to apply the most efficient financing contract that is easy to scale up and implement across its branch network. Hence, they utilise fewer profit-and-loss sharing contracts than BMT Muda. The latter is a smaller, nimbler organisation which prioritises its social mission over short-term profits and so is more capable of offering a wider variety of financing contracts including profit-and-loss sharing. Nevertheless, there are greater financial costs at stake for impoverished beneficiaries from equity-based products because they are less convenient and not competitive with conventional products. Therefore, Islamic MFIs offer the lowest financing costs to retain customers because high margins will deprive beneficiaries of crucial funding to support their families. Coupled with the convenience of recognisable debt-financing products like *murabaha*, a greater demand for debt-financing emerges over profit-and-loss sharing.

5.5 *Hiyal* (Islamic legal fictions) and hybrid contracts

While classical contracts form the basis of all Islamic MFI operations, some modifications are made to better suit the context of beneficiaries. The most notable example is *murabaha bil wakalah* which was developed (much like in IBF) to enable a more efficient and convenient processing of cash financing to meet beneficiaries' pressing financial needs.[63] Under this contract, the customer is still required to purchase an asset but can undertake this on their own

[63] Kustin's extensive fieldwork in Bangladesh and Pakistan has shown the importance of access to fungible cash over other assets for poor borrowers.

or via an Islamic MFI-authorised relative or a friend. Under either circumstance, the Islamic MFI does not procure the asset itself but appoints an agent on its behalf and then arranges a credit sale to the end beneficiary who repays by credit instalments over an agreed term. If the original cost price is not disclosed or known, the contract is called *bai-muajjal* (a deferred sale). For many beneficiaries that we interviewed, the distinction between *murabaha* and *murabaha bil-wakalah* was merely procedural. In fact, the latter was more preferred for its convenience and familiarity to other forms of cash financing. However, among the staff and management of Islamic MFIs, they expressed some concern due to its procedural deviation from the classical *murabaha* since they could not always verify with certainty that the customer had acquired the asset for which they had contracted. Sometimes, the Islamic MFI staff member reviewed an invoice or purchase order to confirm compliance.

The *murabaha bil wakalah*, much like many hybrid contracts used in the general IBF industry, was developed on the basis of essential need (*darurah*) that would otherwise cause undue hardship or inconvenience for stakeholders. For Islamic MFI beneficiaries who face short-term liquidity crunches or require an asset that the Islamic MFI cannot feasibly procure, store and sell, the *murabaha bil wakalah* solves the problem without compromising Shari'a ethical principles. The clear approval by the Islamic MFI Shari'a boards and further confirmation by the DSN-MUI representative in East Java, demonstrates how a balance has been struck between money-for-money transactions (the 'riba'-concern) and the convenience / practicalities required for transactions. This hybrid contract helps overcome the cumbersome nature of procuring an asset, storing it and then transferring to the "borrower". In this instance, scholars have listened to stakeholders and then integrated the context into the elaboration of law and jurisprudence.

5.6 Promotion of debt-based financing

The use of legal fiction (*hilah*), the widespread adoption of *murabaha bil wakalah* as the most convenient financing tool by Islamic MFIs, raises the concern that Islamic MFIs are promoting more debt-based instruments as opposed to pure-form profit-and-loss contracts. When exploring the rationale and motivations with Islamic MFI staff and the Shari'a boards, two key points are worth noting. First, the contracts are still formally valid under Shari'a and so they can be utilised to meet a specific need. Secondly, the usage of debt-based instruments at the grassroots is driven by consumer demand rather than pushed by the Islamic MFI. As noted earlier, this is because debt-based instruments have greater convenience and customers find them more familiar. Moreover, Islamic MFIs have fewer resources and narrower profit margins to expand on costly profit-and-loss schemes unless they provide cost-effective financing solutions for impoverished beneficiaries.

Overall, an Islamic MFI's core objective is to generate positive impact for their members in terms of offering more humane financial products and to ensure compliance with religious tenets. To that extent, Islamic MFIs have an even stronger maqasid argument than conventional IBF financial institutions in that they are utilising hybrid contracts in challenging circumstances, with marginalised customers and with clear socio-economic objectives in mind.

5.7 What is deemed most important to stakeholders

Our fieldwork validated findings elsewhere that noted convenience and customer-friendly service are top considerations for beneficiaries.[64] Due to the poor's limited education and time constraints, an Islamic MFI's carefully-considered services for where and when to collect repayments and its simplified application processes were viewed most favourably. The level and quality of service were the main attributive factors that determined an Islamic MFI's Islamic-ness 'credit rating' compared to the extent by which it formally complied with the technical Shari'a rules. For many beneficiaries, *Shari'a* compliance was the 'ethical dividend' evident in lower or fairer prices, leniency and flexibility with repayments, convenience of access to MFI staff[65], assistance during family emergencies and additional support (in the case of BMT).

Beyond these direct services, Islamic MFIs enhanced social capital via building direct member connections on the basis of solidarity and brotherhood. This was overt in BMT Muda's case because all beneficiaries have to be members whereas there is no similar requirement for BPRS. BMT Muda's members can also attend AGMs to shape the outcomes of the organisation. Through the provision of financial services, the transfer of religious teachings and support of religious activities (e.g., visits to pious predecessor's graves), BMT Muda enhanced the distinct Islamic identity of their members.

[64] Put reference
[65] For BPRS Mitra Syariah, beneficiaries preferred to deal with staff at the *pasar* (traditional market) where they frequented regularly for business and for BMT Muda, staff would conduct visits at members' houses.

Ramadan notes that the crisis in Muslim countries is largely a legal issue. From his perspective, 'Muslims throughout the world are experiencing a deepening crisis of identity and confusion about their faith's principles and practices.'[66] The apparent and alleged disconnect between the identification of rules and their purposes, indicative of IBF, is one of the claimed causes of Muslim *anomie*. However, this case study of Islamic microfinance members indicates the reverse; that in the face of a multitude of competing options, Islamic MFIs are capable of strengthening Muslim social ties based on faith, through daily financial transactions and the bonds that form through social activities.

6. To what extent are Islamic ethics alive in the operation of Islamic microfinance?

If we return to the argument of Ramadan, he stated that IBF, and by implication Islamic microfinance, is 'legitimating an unethical capitalism.' Taking a maqasidic view point, our case study indicates Islamic microfinance *is* ethical as first and foremost it diverts borrowers from interest-based conventional microfinance as well as the exploitative practices of unscrupulous money lenders. The primary consideration of Islamic ethics is to avoid activity expressly prohibited by the Shari'a. Further, contrary to the notion of a selfish and individualist ethic, our case study demonstrates that Islamic microfinance directs towards social empowerment through building solidarity and community.

As for Ramadan's point that Islamic MFIs are engaged in legal subterfuge, passing off pro-consumerism contracts as Islamic, he is correct to the extent that the most popular contract remains the *murabahah* and *bai' mu'ajjal* whose deferred terms replicate the characteristics of fixed interest-based, debt contracts. Their structure and outcomes are not representative of the Islamic ideal of profit and loss sharing contracts. The subterfuge is also there as the Islamic MFIs are making extensive use of hybrid contracts and *hiyal*, so that even the *murabahah* is joined with a *wakalah* (agency) contract to make conventional cash-based debt financing contracts appear 'Islamic'. There is also the question whether the hybrid complies with the classical Shari'a as contracts are agreed before their details are known (implying potential *gharar*).

[66] Ramadan 2013, at 105

Nevertheless, to argue that the Islamic MFIs have lost all their 'Islamicity' for these weaknesses is arguably extreme given the actual circumstances in which the resort to hybrid contracts and *hiyal* is made. The *murabahah bil-wakalah* was developed to fulfil an essential need – *darurah* – which is an Islamic concept. Moreover, just as the '*salam'* or agricultural forward sale was justified on grounds of practical necessity and seen in the classical Islamic literature as an exception to the rule that purchase and sale items must 'exist' in the market place before they can be contracted, one could make the same argument here. It should be noted that Indonesian, local, Muslim scholars on the Shari'a regulatory board (DSN-MUI) have approved it. As for the presence of *gharar*, that remains a matter for ongoing review and consideration by the Islamic MFI and the DSN-MUI. This process of review, reflection and refinement are essential stages of inner struggle (*jihad*) against one's lower self to achieve *ihsan*. We believe that a wholesale dismantling of IBF and especially Islamic microfinance is not necessary to make the necessary improvements in grassroots implementation.

A third, and more implicit, element of Ramadan's argument is that even if IBF and Islamic MFIs are offering services technically in line with the Shari'a, they are hollow shells, 'relying on Arabic and Islamic terminology and on frequently petty formal readjustments ….. techniques rather than substance, apparent means more than higher ends.'[67] But what Ramadan fails to acknowledge is the sociological phenomena whereby law can enhance social bonds, build social capital and shape identity as is evident in the operations of Islamic MFIs in Indonesia. The ethical is not provided merely by the law, but also by the behaviour and values of the *people* who operationalise it.

Al-Raysuni, commenting on the work of the Maliki scholar, Al-Shatibi, summarised the essence of the the *maqasid* and every ruling of the Shari'a as embodying 'a form of kindness and blessing for human beings.'[68] Ethical development requires 'humanity' and the infusion of the moral (*husn al-khuluq*) through all stages of implementation. Chapra writes: 'honesty, fairness, punctuality, conscientiousness, diligence, self-reliance, tolerance, humility, thrift, respect for parents, teachers and the elderly, sympathy and care for the poor, the handicapped and the downtrodden…can lead to mutual trust and cordial relations among the people and

[67] Above note, 2009, at 82.
[68] Ahmad al-Raysuni, 2005. Imam Al-Shatibi's Theory of the Higher Objectives and Intents of Islamic Law, trans. Nancy Roberts, IIIT, Herndon, Virginia, p. 16.

motivate them to fulfil their mutual obligations and to help each other…This will lead to an increase in social capital, which is necessary for promoting efficiency and equity and, consequently, accelerated development and human well-being'.[69] It is within this holistic conception of ethics and the refinement of character, therefore, that we build 'community' and realise 'development'.

The fundamental sociological and macroeconomic questions that Ramadan raises are beyond the capabilities of Islamic MFIs on their own to affect in the short-term. Rather, Islamic MFIs are providing an alternative for under-served segments and financially excluded populations who, through them, can obtain a more compassionate service that is also consistent with their religious beliefs. Ramadan fails to acknowledge the short-term grassroots benefit that *Shari'a*-compliant institutions can bring both through rules preventing the usurious compounding of arrears as well as the qualitative development of solidarity and brotherhood among members. Through both efforts to empower underprivileged communities financially and the imparting of religious guidance to enable the Muslim poor to lead sustainable, balanced lives, Islamic MFIs are generating a groundswell movement to change people's behaviours. This cannot be achieved on their own but through partnerships with religious organisations, civil society groups, regulators, policymakers and the private sector. Moreover, Ramadan's call for fundamental rethinking of economic models is not mutually exclusive. Islamic MFIs are becoming more successful based on a combination of top-down policy change and bottom-up behavioural change. All are required to achieve a more just society based on a holistic set of *Shari'a* principles.

7. Conclusion

As we have argued and demonstrated in this paper, Islamic microfinance presents a bright light within the Islamic banking and finance universe. We contend that in critiquing Islamic finance, Ramadan has overlooked the value and importance of Islamic microfinance to the extent that it is purpose-driven and fulfils the *maqasid* by way of enhancing solidarity, justice and brotherhood.

[69] Chapra (2008): 'The Islamic vision of development in light of the maqasid al-shari'a', file:///C:/Users/sfar6116/Downloads/TheIslamicVision.pdf, accessed on 14 November 2019.

However, zooming out of microfinance, it is important to note that microfinance is not a panacea for all of the socio-economic challenges of underdeveloped countries. There is evidence to question the "silver bullet" rhetoric that pervaded global development and poverty alleviation circles around the time of Muhammad Yunus and Grameen Bank's recognition for the Nobel Peace Prize in 2006. And within the Islamic microfinance sector in Indonesia, the majority of Islamic MFIs have been mismanaged through institutional and regulatory neglect. These two phenomena should keep all Islamic microfinance stakeholders on edge about their role to ensure that the welfare of the most vulnerable is not harmed and injustice is not caused.

We contend that a properly managed and effectively regulated Islamic MFI that operates purposively for holistic socio-economic development is a guard against unscrupulous financial services and can direct individuals and communities onto a positive development pathway. Islamic microfinance can generate immense positive socio-economic impact for members and enhance social capital in grassroots communities. However, on its own it is incapable of addressing the negative mega trends that are leading the earth towards social and environmental upheaval and which Ramadan is correct to note is not adequately addressed by the *ulama* and Muslim governments.

Additionally, just because an institution adopts *Shari'a*-compliant financing contracts and obtains *Shari'a* certification[70] does not correlate with organisational success, let alone adherence to *Shari'a* principles. In fact, for much of Islamic MFI history in Indonesia, the vast majority of (primarily informal) Islamic MFIs are underperforming and riddled with institutional incompetence and neglect.[71] Seibel's study was one of the first comprehensive evaluations of the sector and it found that most Islamic MFIs suffer from mismanagement and regulatory neglect.[72] He estimated that only one-fifth of BMTs are in reasonably good health which means that many members' savings are at significant risk. More recently, Nasution's literature review concluded that the relatively low performance of Islamic MFIs can be

[70] Certification is not an onerous process. While BRPS and LKMS' annual reports and Sharia supervisory body audit reports are reviewed by OJK, all that BMTs must do to obtain Sharia certification is for their management to attend training conducted by DSN-MUI and to pass an examination. There is little follow-up and oversight of Sharia compliance by the MoCSMEs due to resourcing constraints.
[71] Hans Dieter Seibel, "Islamic Microfinance in Indonesia: The Challenge of Institutional Diversity, Regulation, and Supervision," *Journal of Social Issues in Southeast Asia* 23, no. 1 (2008)..
[72] Ibid.

attributed to lack of effective management,[73] external supervision and development assistance.[74]

These institutional shortcomings arise from the market failure between demand for Islamic microfinance services and the supply of quality institutions. The gap is currently met by unregulated, informal and unsophisticated entities that cannot sustainably meet clients' needs. Unlike the BPRS which are supervised by OJK, BMTs face significant regulatory and supervisory neglect outside those backed heavily by Islamic mass organisations. Also, the MoCSMEs lack sufficient resources and do not have a nationwide comprehensive program to support BMTs. Beyond ad-hoc funding via Indonesia's Ministry of Social Affairs program, called *Kelompok Usaha Bersama*, and some limited *Shari'a* compliance and management training in conjunction with DSN-MUI (which has limited coverage across the archipelago), BMTs require greater operational guidance, oversight and funding assistance to effectively eradicate poverty.

Islamic MFIs still face typical institutional challenges that are common to any organisation, especially in an environment of regulatory neglect amidst considerable financial market failures. This phenomenon undermines Islamic MFIs' ability to effect holistic socio-economic development and may even undermine key principles if corrupt practices seep in. Nonetheless, these limitations and challenges do not necessarily stem from the *usul* framework and implementation of *Shari'a* ethical principles as Ramadan focuses on in his proposal for radical reform. The democratisation of information on social media and other digital sources through the proliferation of smartphones, has ensured more beneficiaries are aware about the practices of Islamic MFIs. With further access to information and deeper reforms and regulatory strengthening, as has been occurring since the Susilo Bambang Yodhoyono era, and with a new Islamic microfinance regulatory framework, Islamic MFIs will be better placed to achieve their development objectives.

Through both efforts to empower underprivileged communities financially and the imparting of religious guidance to enable the Muslim poor to lead sustainable, balanced lives, Islamic

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[73] See Widiyanto and Ismail (2010), cited in Atiqi Chollisni Nasution, "Efficiency of Baitul Maal Wa Tamwil (Bmt): An Effort Towards Islamic Wealth Management in Microfinance Institution," *The Journal of Muamalat and Islamic Finance Research* 11, no. 1 (2014).XX.
[74] See Kholis (2009) and Amalia (2009), cited in ibid..

MFIs are generating a groundswell movement to change people's behaviours. This cannot be achieved on their own but through partnerships with religious organisations, civil society groups, regulators, policymakers and the private sector. Moreover, Ramadan's call for fundamental rethinking of economic models is not mutually exclusive. Islamic MFIs are becoming more successful based on a combination of top-down policy change and bottom-up behavioural change. All are required to achieve a more just society based on a holistic set of *Shari'a* ethical principles.

Appendix 1: Typology of Islamic financial products

1. *Financing products*

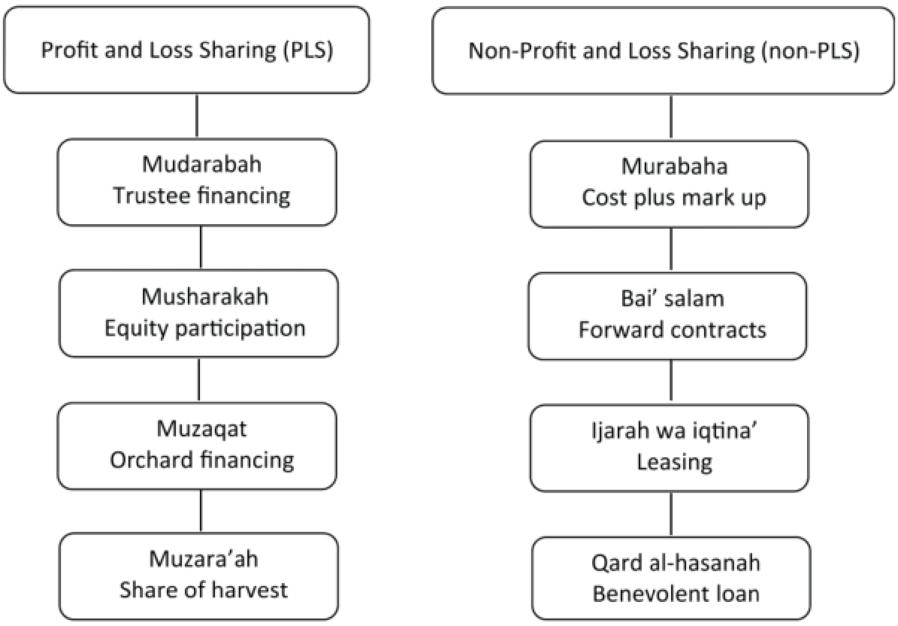

Figure 7.1: Types of Islamic Finance Contracts. Fianto and Gan (2017) (p. 255).

2. *Deposit products*

3. *Insurance products*

Source: Adapted from Seibel (2008) https://www.econstor.eu/bitstream/10419/23656/1/2006-2_INO_IslMF.pdf (p. 13).