

# Stages of the Islamic Social and Commercial Financing for Microfirms

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**Abstract:** *Zakah*, *shadaqah*, and *waqf* are among the Islamic social funds work as instruments for poverty alleviation. Islamic social funds in Indonesia collect through authorized *zakah* institutions. This study analyzes how *zakah* institutions provide micro financing in several stages to develop micro-business. We interviewed three zakat institutions in Indonesia. We found that micro-business financing through zakat institutions provided in three stages. Each stage has different schemes and provisions. At the first stage, the fund granted to individuals without an obligation to pay the fund back. It is a *zakah* fund distributed according to a transfer payment scheme. In the second stage, financing provided to individuals or business groups with interest-free repayment. It is a non-zakat social fund used to finance a micro business with 0% interest, lower than the market rate for micro-financing. Moreover, the repayment at this stage is not to the zakat institution, but rather to the group, either become revolving fund among group members or become group-owned resources. The third stage is commercial financing using *murabaha* or profit sharing scheme.

## 1 INTRODUCTION

Globally, micro finance is encouraged as one of the main instruments to alleviate poverty. The United Nations Children's Fund, formerly known as the United Nations International Children's Emergency Fund (UNICEF), combines access to micro credit and social services as an effective and efficient approach to getting people out of the poverty chain. In Indonesia, the development of micro enterprise units is certainly not apart from the provision of financial services micropreneurs can use. The development of micropreneurs is important because about 99% of them Indonesian business is categorized as microfirm and absorbing a large labor force.

Islamic financing is divided into two broad categories, social funding and commercial funding. Islamic social funds consist of *zakah*, *waqf*, *infaq*, and *sadaqah*. Islamic social funds are allocated for several social activities. Typically, *zakah* is an obligation payment made by the wealthy to the poor, and in this capacity it functions as a measure to reduce poverty. *Zakah* funds given to *mustahik* can play a role in supporting economic activities when allocated to productive activities. Asnaini (2008) states that productive *zakah* is given to *mustahik* as business

capital to meet their basic living needs. The utilization of productive *zakah* is expected to overcome the credit crunch that often occurs in the micro sector.

Islamic finance has multiple roles that support each other, namely social interests and business interests. Islamic micro finance also plays a role in receiving and distributing *zakah* funds, *infaq*, and *sadaqah* for social causes. It receives these funds from the public for distribution to eligible communities. Islamic micro finance also has an important role to play in developing productive business in the micro sector. *Zakah* management institutions in Indonesia use social and commercial financing schemes simultaneously (Obaidullah and Khan, 2008).

This study examines the financing scheme run by the *Zakah* Management Institution (ZMI) in Indonesia, which often provides financing by integrating social funds with Islamic commercial funds. Specifically, this research aims to evaluate how the disbursement of funds is implemented in the context of poverty reduction. This research is expected to contribute to the development of Islamic micro financing schemes to alleviate poverty and promote economic growth, especially in Indonesia.

The second section of this article describes literature studies related to the idea of the role of Islamic micro finance and how the *Zakah*

Management Institution (ZMI) plays a role in the process of poverty alleviation and economic empowerment simultaneously. The third section presents the methodology used, while the fourth section presents the results and discussion. The last part of the paper presents a conclusion followed by a list of the references used.

## 2 LITERATURE REVIEW

### 2.1 The Need for Micro Finance

The financing of micro firms has long been acknowledged as a mechanism to alleviate poverty in developing and developed countries. According to Rahman (2007), this system focuses on addressing the needs of the poor. World Bank (1999) states that micro finance refers to the provision of financial services to low-income communities, including self-employed communities. These financial services include the provision of micro savings and micro loans. Micro firms are an important sector in the Indonesian economy because they account for more than 95% of business units and provide more than 98% of the labor market. But the high cost of micro firm financing has become a major problem in achieving the goal of alleviating poverty. This high cost problem reduces the chances of business survival and the ability of micro firms to grow. They operate mostly under the prevailing levels of economies of scale because their limited capital prevents them from growing beyond the micro stage. The growth of these micro businesses is also stunted by a lack of innovation and insufficient business skills on the part of managers or owners.

### 2.2 The Role and Potential of Islamic Social Funds

In the Islamic economic system, among the many sources of philanthropic funds aimed at alleviating poverty are zakah, infaq, and waqf, among others. El-Din (1986) states that zakat is a tool or instrument to eradicate poverty. These funds should be able to provide financing to micro firms at a very low cost. According to Mohieldin (2012), the main focus of Islamic finance is risk sharing and the redistribution of wealth. According to research by Badan Amil Zakat Nasional (BAZNAS) in 2015, the potential collectable total of zakat in Indonesia amounted to Rp286 trillion. However, in 2015, the total amount of zakat, infaq, and national alms collected represented only 1.3% of its potential. The distribution of zakat in

Indonesia is carried out through consumptive and productive distribution by the Zakah Management Institution (ZMI). Asnaini (2008) states that productive zakat should be provided to mustahik as business capital.

## 3 METHODS

The research design in this paper is the qualitative method, using the case study approach and in-depth interviews. The research object was chosen using purposive sampling. Thus, we selected three ZMIs that developed a zakah fund-based micro financing program. The ZMIs are:

- Dompot Dhuafa, one of Indonesia's largest charitable organizations, which developed a program called Ikhtiar Swadaya Masyarakat (ISM) Sumber Rezeki Dompot Dhuafa;
- LAZ Al-Azhar, a nonprofit organization, which developed a program called Kelompok Swadaya Masyarakat (KSM) Pelita Jampang Gemilang LAZ Al-Azhar;
- LAZ IZI, which developed a program called KUMM Ciranjang LAZ IZI.

In this study, interviews were conducted with officials who understand how the programs were developed. Interviews were conducted at Dompot Dhuafa with the President and Director of PT Dompot Dhuafa Niaga, as well as with the Chairman of ISM Sumber Rezeki, and ten program participants from ISM Sumber Rezeki. An interview at LAZ Al-Azhar was conducted with the Chief of Da'wah & Social Affairs, Head of the Program & Utilization division, and ten members of KSM Pelita Jampang Gemilang. The interviews at LAZ IZI were conducted with the Director of Empowerment, as well as the leader of KUMM Ciranjang and seven of its members.

## 4 DISCUSSION AND ANALYSIS

The funding sources of Islamic micro finance run by ZMIs come from zakah payers, Infaq, and Sadaqah (ZIS). The nature of ZIS funds is that there is no payback on the funds. ZMIs act as the party that channels the ZIS funds to those eligible to receive them (mustahik), especially zakah funds. ZMIs pay zakah to mustahik directly. Zakah funds do not need payback. However, those who qualify for zakah funds are only people in certain categories, such as the poor, among others. Zakah funds can be used for

consumption as well as for production activities. In the next stage, business actors may be provided with funds that are interest free (qard hasan) to finance current or newly started business activities. The principal of this loan should be paid back, but instead of being returned to ZMIs, the funds are returned to the group or become a revolving fund among group members. As for the next stage, financing is classified as commercial and is provided only to finance a business that shows good prospects. In the following sections, we present a summary of microfinance programs run by three evaluated ZMIs.

### 4.1 First Stage: Grant with Zakah Fund

Zakah is paid to mustahik according to the provisions of Islam, such as for the poor. Zakah is granted without having to be returned. The challenge for ZMIs in channeling zakah funds is to ensure that the beneficiaries are among those eligible to receive zakah. Mustahik can use the zakah funds to meet their basic needs (consumption) or for production activities. Distributions of zakah funds by the three ZMIs evaluated are similar.

### 4.2 Second Stage: Interest-Free Loan

The second stage in the Islamic micro finance process is the most distinguishing stage, with conventional micro finance. In this stage, the financing is given as interest-free loans (Qard hasan scheme). In conventional micro financing a loan is charged interest. Similarly, micro finance is a government program, although the interest charged is quite low due to government subsidy. The source of funding for this financing is the infaq and shadaqah Muslims paid to the ZMIs. Infaq and shadaqah are also funds that do not need to be repaid. Also, Islam prohibits lending accompanied by an obligation to pay interest. However, there is no rigid provision on how to channel funds from infaq and sadaqah, which are different to zakah. Thus, ZMI can be more flexible in making rules for distributing these funds.

The channeling of infaq and shadaqah funds from all three evaluated ZMIs shows some characteristics similar to those of micro finance in general. Table 1 presents a summary of these characteristics.

Overall, Islamic micro finance practices conducted by the three ZMIs here conform with the criteria presented by experts such as Masyita (2012) and Tavanti (2012). However, what distinguishes ZMIs' financing from other micro finance is that the micro finance business model adopted by ZMIs

focuses on empowering others, so it is not oriented toward maximizing profit for the institution.

Table 1: Characteristic of microfinancing by ZMIs: 2<sup>nd</sup> stage.

Features	Characteristic	Dompot Dhuafa	LAZNAS Al-Azhar	LAZNAS IZI
Participants	The pors (low income household)	√	√	√
	No or low physical assets as guarantee	√	√	√
	micropreneurs	√	√	√
Loan terms	Small amount financing	√	√	√
	Group guarantee	X	X	X
	Easy and informal prosedures	√	√	√
	Loan period	Up to 8 months	Up to 10 months	Common capital for group
	Repayment	Revolving loan in group member	Revolving loan in group member	
Business aspects	High risk profile of micropreneurs	√	√	√
	Type of business	Individual or household business	Individual or household business	Group business
	Cost of loan	zero	zero	zero
Empowerment	Routine meeting of group members	weekly	weekly	Daily to do business activity
	Savings requirements	Voluntary, but suggested	At least Rp 1.000 per week	Voluntary, but suggested
	Savings management	By group leader	By group leader	By group leader
	Learning process in business activities	√	√	√
	Network building	√	√	√
	Social control for repayment	√	√	X

### 4.3 Third Stage: Islamic Commercial Loan

In the third stage, the funds are provided for commercial financing. The amount of financing is greater than that provided in the first and second stages. This financing requires repayment and returns, according to the terms of the scheme used. Program participants must show that their business activities are already running and have good prospects. Participants are also required to submit collateral in the form of personal assets.

The process for granting finance in this stage is carried out using the accepted prudential principles of the 5Cs (character, capacity, condition of economy, capital, and collateral). The evaluation of financing by the three ZMIs is based on the criteria of the 5Cs

+ 1S (S relates to aspects of sharia). For example, business activities must not engage in prohibited goods or services, and these activities must comply with the provisions of sharia.

In this commercial financing process, priority is given to prospective borrowers who have a higher rate of return on business than prospective borrowers who are among the poorest. Moreover, financing in this stage tend to require collateral. Features of financing for this stage is presented in Table 2.

#### 4.4 Impact of the Program

The impact of each ZMI program on the relevant business actors was measured by interviewing ten households from the community groups of Sumber Rezeki built by Dompot Dhuafa, ten households from the Pelita Jampang Gemilang group from Al Azhar, and seven households from the Cijarang group under IZI. The interviews revealed that most program participants acknowledged an increase in income. Households from the Sumber Rezeki group built by Dompot Dhuafa said they had experienced an increase in income from about Rp30,000 per week or to an estimated average of Rp2.5 million per month. The Cijarang group, built by IZI, consists of housewives. They reported that they have a business with an average income of Rp600,000 per month, whereas previously they had no income generation at all. Meanwhile, the group of Pelita Jampang biaan Al Azhar reported an increasing scale of business. In addition to the impact on revenues and business scale, the three business groups of each ZMI showed a significant increase in the amount of their savings. The members of these groups are encouraged to save during every routine group meeting, which has helped create saving habits among program participants.

Table 2: Characteristic of microfinancing by ZMIs: 3<sup>rd</sup> stage.

Features	Characteristic	Dompot Dhuafa	LAZNAS Al-Azhar	LAZNAS IZI
Participants	Micropreneurs having viable business activities	√	√	√
	Type of loan	Individual based	Individual based	Group loan
Loan terms	Higher amount financing	√	√	√
	Collateral requirement	√	√	√
	Type of collateral required	Personal assets	Personal assets	No clear guarantee
	Financing scheme and cost of fund	Murabahah-8% margin	Musarakah – profit and loss sharing	Murabahah or musarakah

Mitigation to information asymmetric	Mitigation to adverse selection problem	Business performance evaluation	Business performance evaluation	Business activity evaluation
	Mitigation to moral hazard problem	Saving records	Saving records	Business activity evaluation
		Repayment record at 2 <sup>nd</sup> stage	Repayment record at 2 <sup>nd</sup> stage	Business activity evaluation
		Collateral requirement	Collateral requirement	Collateral requirement

## 5 CONCLUSIONS

In general, micro finance on the three ZMIs evaluated operates in three stages. In the first stage, financing is a form of zakat payment that does not need to be paid back. The three ZMIs carry out this process in a similar way. In the second stage, financing is a form of interest-free loan or qard hasan. The source of funds for this financing is infaq and shadaqa, which do not require the money to be repaid to the person paying the infaq or shadaqah. However, the principal of the loan must be returned by the business actors to the business group, either as a revolving fund or as joint group capital. The third stage, commercial financing, is evaluated based on generally accepted prudent principles and consists of cost for the financing. Besides being conducted in stages, the financing programs provided by the three ZMIs are accompanied by regular mentoring and training activities. Finally, surveys conducted on program participants indicate that the program has had a positive impact. This improvement is evidenced by the significant increase in the scale of business, household income, and participants’ savings. However, further research is needed to evaluate the impact of ZMIs’ micro finance programs on program participants and what variables have an impact on income improvement, business scale, and savings.

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