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Harnessing Islamic  
microfinance

Minako Sakai  
Kacung Marijan

POLICY BRIEFS

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## Harnessing Islamic microfinance

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## About this policy brief

This Policy Brief presents findings from research funded by the Australia Indonesia Governance Research Partnership (AIGRP).

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# Harnessing Islamic microfinance

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## 1. Introduction

Islamic credit cooperatives (*Baitul Maal Wat Tamwil* or BMT) are an emerging provider of micro-finance in Indonesia. BMTs are a grass-roots development supported by funds from Islamic community members. These micro-finance organisations usually operate on the principle of profit-loss sharing and use Islamic moral values and group solidarity as social capital to encourage repayment of loans. Group solidarity is fostered through regular meetings and counseling. BMTs sometimes themselves also run retail businesses to support micro-finance schemes.

Some of the financial products and services offered by BMTs are similar to those of Islamic banks and syariah rural banks (BPRS). However, they differ markedly in terms of patronage, with Islamic banks drawing mainly middle class, white collar Muslims, and BPRS mainly providing services for Muslims from middle and lower income groups. While there is some overlap between the clients of Islamic banks/BPRS and BMTs, many BMT customers are Muslims who run small and medium enterprises and whose access to banks is relatively limited.

The development of Islamic finance into a modern financial system in Indonesia dates back to the establishment of the first Islamic bank, Bank Muamalat in 1991. Support at that time came generally from Indonesian Muslims, rather than the government. However, the majority of the Muslim population neither understands nor trusts the system, and consequently Islamic banks' market share is still small. Nevertheless, our research revealed that the BMT movement has been developing without much support, systematic supervision or regulation from the Indonesian government to date. Muslim economic activists are the main drivers of the BMT movement in Indonesia (Antonio 2008, Lubis 2004, Sakai 2008).

The BMT sector in Indonesia has much potential for further expansion subject to the ability of BMTs to address operational weaknesses that have reduced many operators' viability to date. The lack of empirical research on BMTs (Sakai 2008) has led to confusion about how they operate and hampered efforts to understand their needs. BMTs are often regarded as Islamic micro-financing institutions, with a similar legal basis to cooperatives. Other studies have classified BMTs as private financial institutions, playing a comparable role to that of banks in Indonesia. These studies have hence emphasised the need for financial and legal reform of BMTs. Taking this approach, Seibel (2008) suggested that BMTs, along with the rest of the cooperative sector, needed a comprehensive overhaul, and has recommended that the rural banking sector (commercial and Islamic, which are more experienced, regulated and supervised) should move into the micro-finance area because most BMTs were dormant and technically bankrupt due to a lack of regulation and supervision.

However, this research found a more complex situation with some BMTs thriving and expanding their businesses, whilst others were being driven to bankruptcy by borrower default. The key findings of the research are summarised below:

- Most BMTs are run by social entrepreneurs with a strong commitment to establishing social justice based on Islamic principles. Leadership and commitment significantly affect operational success as much as the presence of regulations.

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- In order to achieve this social justice objective, most BMTs offer three services (micro-financing, *zakat* and social welfare programs, and business/entrepreneurial training) to their members and the community. They are fundamentally social enterprises, distinctively different from business-oriented ventures.
- Various BMT associations and institutions (the BMT Center, PINBUK and regional and national BMT associations) are actively creating self-regulation codes and standard operational procedures.
- Lack of promotion of BMTs' services in general has hampered the growth of BMTs. It has created the perception that BMTs are charity organisations. Such perceptions have created problems for BMTs in ensuring repayment of loans.
- Some BMTs run other business enterprises. Success or failure of side businesses often impacts financially on BMTs' operations.

### The legal and regulatory context for BMTs

While Islamic banks and BPR Syariah are regulated by Banking Law and supervised by the Bank of Indonesia, the regulations for the BMT sector involve a more complex arrangement as described below<sup>1</sup>.

- From an institutional perspective, the establishment of a BMT is based on a Letter of the Minister of Home Affairs No 538/PKK/IV/1997 issued on 14 April 1997, concerning the Legal Status of Syariah Financial Institutions (Status Badan Hukum untuk Lembaga Keuangan Syariah).
- Norms for regulating membership of BMTs are regulated by Islamic Law under KUHD (Kitab Undang-undang Hukum Dagang).
- Arrangements for initial capital funds and members' savings are regulated by Law No 25 1992 on Cooperatives.
- The Baitul Maal (house of treasury) function is controlled by Law UU No 38/1999 on Management of *Zakat*.

Due to this legal complexity, the micro-finance services of BMTs suffer from a lack of supervision and reporting. In order to improve this situation, various options are under discussion.

- The Bank of Indonesia is keen to encourage BMTs to convert into banks (BPR Syariah). Under the Banking Law, BMTs would need greater capital to operate, and this would likely precipitate several mergers of BMTs. The Banking Law would also require modern management with managers needing to pass an examination. Many new and small BMTs do not have the resources to train their employees to the required standard.
- The Ministry of Cooperatives intends to accommodate BMTs under its jurisdiction as cooperatives. For this, the Deputy Minister of Cooperatives and SMEs, Marsidi Rahardjo, has proposed an amendment of Law No.25 1992 on Cooperatives to clearly incorporate BMTs within the existing Law (Aziz 2008).
- The Department of Finance is considering special regulations for micro-financing services which would apply to BMTs. This would mean BMTs were to be viewed in the same manner as any other microfinance institution.
- The BMT sector itself is determined to seek a law on BMTs which reflects their multiple functions as both microfinance and social institutions.

## 2. Supporting business through social entrepreneurship

Social entrepreneurship is an emergent subfield in entrepreneurship studies. It is 'a process involving the innovative use and combination of resources to pursue opportunities to catalyse social change and/or address social needs' (Mair and Marti 2006:37). The defining characteristic of social enterprises is that they are driven by a sense of mission and social values, not solely by maximising private gains (Certo and Miller 2008:267). For example, the company profile of BMT Beringharjo (a leading BMT in Yogyakarta) describes its services as 'Not only providing financial assistance and saving facilities', but also entrepreneurial motivation and training sessions for its members.

Identifying BMTs as social enterprises is important for two reasons. Firstly, social entrepreneurs and their ventures, are capable of finding effective solutions to social problems, if public policy 'recognises and deliberately harnesses' their potential (Dees 2007:29). The implication is that we need to be cautious about creating a more rigid regulatory environment, as previously recommended. This is because BMTs have developed as cooperatives, offering more flexible financing schemes than banks. Enforcing the same regulatory rules to the financial services of the BMTs would therefore make BMTs' services less attractive.

Secondly, identifying BMTs as a social venture will necessitate a new framework to evaluate and identify the capacity-building needs of BMTs. This is because the operators of social ventures gauge their success not solely by typical business growth measurements such as profitability, employee numbers and asset size (Sharir and Lerner 2006). Our research has found that BMT operators are strongly concerned with offering entrepreneurial skills, promoting Islamic values and much-needed funds to a larger number of clients in a viable way. For example, TAMZIS limits its maximum loan amount to 5 million rupiah per client and collects repayments on a daily basis. This has a significant impact on the business direction and strategy. The strategy reflects the nature of BMTs themselves, as not merely microfinance institutions, but also as social institutions.

However, social enterprises also encounter similar problems to business enterprises at various stages of their business development. Social enterprises also need to effectively overcome difficulty in 'identifying opportunities and needs, planning and acquiring support information and resources, marketing and creating demand and constructing organisational frameworks' (Young 1986 cited in Sharir and Lerner 2006:7).

### **Accumulating and focussing social capital**

Social capital is the foundation upon which the BMT industry is built. Success is highly dependent on the quality of leadership and the ability of leaders to generate and direct social capital. Our research has found that the currently successful BMTs still have their founders involved in their day to day operations.

BMT managers view Islamic values as important in improving human resources. For example, BMT Beringharjo and BMT Al Ikhlas run training programs for their employees on a regular basis. One of the training programs emphasises self-discipline. In order to promote professional conduct among their employees, values taken from the Qur'an are directly linked to operational activities. Employees are constantly reminded that they have to be accountable in the eyes of God.

### **Strong supporters of SMEs**

The majority of business activities in Indonesia are micro, small and medium enterprises. In 2007, the number of micro-enterprises accounted for more than 91 per cent of all



businesses, or around 44 million enterprises. Their ability to absorb labour means they have great potential to create employment and reduce poverty. Therefore, the Indonesian government has paid significant attention to growing SMEs and has offered various programs, consisting of technical and financial assistance. However, these programs have only been partly successful (Berry et al 2001; Hill 2001; Marijan 2006; Thee Kian Wie 1993).

Concessional credit, for example, has resulted in a high number of defaults. As a result, a large number of SMEs have limited access to financial institutions (Antonio 2008). Consequently, SMEs need other alternatives to access finance. On the other hand, clients who can borrow Rp 20 million from BMTs have access to the banking sector including BPRS, usually at cheaper rates. Yet, many SME owners prefer using BMTs due to their convenience and faster loan approval. BMTs' convenient financial services thus help the SME sector grow in Indonesia.

As a community financial institution, BMTs offer SMEs a wider range of services to support their growth such as entrepreneurship training and social empowerment programs.

### 3. Size and distribution of BMTs in Indonesia

The vast majority of BMTs have assets of between Rp 50 million and Rp 500 million (see table 1 below). Data from PINBUK (*Pusat Inkubasi Usaha Kecil*, or Incubation Centre for Small Enterprise) in 2004 (cited in Nadjib 2006:29) shows that 52 per cent of BMTs with assets above Rp1 billion are located in Central Java and Yogyakarta<sup>2</sup>. BMTs in Central Java and Yogyakarta also account for 20 per cent of all BMTs registered with PINBUK, making Central Java a leading centre of the BMT movement in Indonesia. BMTs in East Java represent 19 per cent of all BMTs in Indonesia, but only eight BMTs there had assets over 1 billion rupiah, accounting for 5 per cent of the total in Indonesia. This is somewhat intriguing as East Java has many Islamic boarding schools (*pesantren*) which have thriving non-BMT cooperatives (*kopontren*) attached, yet BMTs are rarely found in the *pesantren* of East Java. This raises the question of why BMTs are not thriving in *pesantren* communities, particularly in East Java.

Table 1: Scale of BMTs

BMT asset size	percentage
BMTs' assets below Rp50 million	9.3%
BMTs' assets between Rp50 million and Rp. 500 million	78.8%
BMTs' assets above Rp1 billion	4.8%

Culture could provide part of the explanation. The Central Javanese culture already features a predilection towards regular meetings, which are essential for BMTs to succeed. As a major centre of tertiary education in Indonesia, Yogyakarta also has a large pool of educated and unemployed university graduates who are attracted to social enterprises such as BMTs.

Another likely factor for the greater success of BMTs in Central Java relative to East Java appears to be related to the different views on business and finance held by Indonesia's two largest Muslim organisations, Muhammadiyah and NU, and their respective geographical heartlands. NU, whose support base is concentrated in East Java, has long viewed BMTs warily, as something promoted by and associated with its rival. The majority of NU *kiai* (Islamic preachers) are also afraid of possible bankruptcy, which they believe could prevent them from entering heaven. Finally, NU leaders tend to view the conventional banking

system as adequate. NU members need to overcome this obstacle if they want to improve the economic conditions in the areas near their boarding schools by means of BMTs.

The high concentration of BMTs in Yogyakarta has enabled the establishment of a BMT forum known as *Pusat Kooperasi Syariah (Puskopsyah)* BMT Mitra Nugraha. The association has 96 member BMTs. Puskopsyah is run by members' contributions and deals with issues such as standard operating procedures of BMTs. Puskopsyah is an effective communication venue for member BMTs and has offered an effective solution to deal with the collapse of member BMTs. BMT MMU and UGT use the alumni of Pesantren Sidogiri as employees and business partners and their business has grown rapidly. Most of the alumni have remained respectful and obedient toward their *pesantren*. Therefore, they tend to avoid inappropriate behaviour towards their *pesantren*, including default on repayment to the BMT.

In contrast to the flourishing BMT scene in Yogyakarta, in Jakarta BMTs do not appear to have the same appeal. Urban middle class people in Jakarta do not show much interest in BMTs and meetings between BMTs in Jakarta are difficult to arrange. BMT Al Kariim in Jakarta started its operation in Jakarta in 1994, and is struggling to increase its assets to more than Rp 4 billion despite its founders having received the same training as BMT Beringharjo, which continues to prosper in Yogyakarta. The managers feel that this is because of the deficiencies in human resources in Jakarta. Educated middle class people in Jakarta are not attracted by the low wages and it is difficult to recruit talented and committed people to manage BMTs.

The manager of BMT Al Amin in Pekanbaru also stated that they hardly ever receive information and useful resources in Pekanbaru even though they belong to supervisory institutions (i.e. PINBUK and Asosiasi BMT). In Pekanbaru no BMTs had a branch in 2008. It is difficult to organise regular meetings among BMT managers in Pekanbaru as the region is spread out.

## 4. Successful and unsuccessful BMTs

### Successful BMTs

In Yogyakarta, BMTs are mushrooming along with other financial institutions (Islamic banks, government-supported micro-financial schemes). These include BKD (*Bank Kredit Desa* or Village Credit Banks) and BPR (*Bank Perkreditan Rakyat*, or Community Credit Banks) all of which are competing with each other to attract a pool of urban traders who need micro-financing in the same area. In order to compete, KSU Subbulussalam, a relatively new BMT in Yogyakarta, has targeted petty traders in the special-hour market (*pasar pagi* or morning market and *pasar malam*, night market), and their niche business is expanding.

BMT Beringharjo is an established BMT, catering for the micro-financing needs of urban traders including the Beringharjo market. It has been operating since 1994 and in 2008 its assets reached 23 billion rupiah. This BMT has continued to assist small and medium enterprises through its *Baitul Tamwil* (literally a house of business), while their *Baitul Maal* (a house of treasury) offers various empowerment programs. Since 2006 BMT Beringharjo has been offering not only saving schemes, but also investment schemes, particularly targeting overseas workers in Hong Kong (Beringharjo Investasi Syariah or BISA). Through this scheme, overseas workers (who are mainly female housemaids from East Java) can become investment partners and establish a new BMT in their hometown. This scheme led to the establishment of new BMT Beringharjo branches in Ponogoro, Madiun, Bandung and Kediri in 2008.

TAMZIS started as a BMT in 1992 in Wonosobo and initially had a *baitul maal* wing attached. However, the members found it difficult to differentiate the *Qardhul Hasan* scheme (not for profit loans) from other for-profit contracts. Many people held a view that repayment was not obligatory. In order to solve this problem, TAMZIS abolished their *baitul maal* and focused on providing micro-finance loans of up to 5 million rupiah to as many members as possible. Therefore, TAMZIS calls itself a *baituttamwil*, rather than a BMT. Its managers believe that daily repayment significantly reduces the risk of defaults and that it is important to investigate the capacity of the borrower prior to the loan approval. TAMZIS regularly provides supervision and training to its members to upgrade their business skills.

BMT MMU and UGT are examples of successful BMTs affiliated with *Pesantren* Sidogiri. They were established by Islamic teachers who knew nothing about technical economics and accounting. But they have been able to successfully learn micro-finance business from other institutions. Recently they introduced a curriculum of Islamic economics in their *pesantren* at Sidogiri. There, some alumni are acquiring basic knowledge about Islamic finance. The close ties among alumni, close contacts with the *pesantren* and other Muslim communities have served as social capital facilitating business partnerships, leading to a rapid growth of BMTs. The BMTs have become partners with petty traders, farmers and medium enterprises. Both BMTs have set up special teams to examine potential clients before approving loans, and then to mediate loan coordination to successful applicants.

### Struggling or stagnant BMTs

BMT Madani began in 1997 in Yogyakarta by offering funds to local farmers. The BMT grew in collaboration with a private bank, BCA, and in 2001-2002, the management started other business ventures (sales of timber and rice). At that time BMT Madani received advice from other established BMTs that such business ventures were risky, but the management did not take this advice. The retail businesses did not grow and repayments from members also started to slow around the same time. Seeing this, other members rushed to withdraw their savings from the BMT, eventually bankrupting the organisation. The majority of the management disappeared immediately, leaving only one manager, a local person, who had to deal with the bankruptcy.

BMT Maskumambang is an example which shows challenges for business expansion in *pesantren* communities. It began with start-up capital of 3 million rupiah and was the first BMT affiliated with a *pesantren* in East Java. After one and a half decades it has total assets of only Rp 25 million of which Rp 18 million remains outstanding because the borrowers do not have the ability to return the money. The lack of committed management is also problematic. Currently, the manager is a daughter of the founder of the BMT and cannot dedicate the time necessary to manage the BMT properly. In addition, inadequate arrangements between the BMT and borrowers also contributed to the near bankruptcy of this BMT. For example, it is not compulsory for borrowers to provide collateral. As a result, when a default occurs, BMT Maskumambang has no measures to collect the debt.

BMT SMS Pacul Gowang is a newly successful BMT run by a *pesantren*. It started with Rp 78 million and after three years had increased its assets significantly, to (Rp 550 million). Before starting their BMT, BMT SMS Pacul Gowang received training from BMT MMU Sidogiri. It also received technical training from other institutions. However, its future growth and business opportunities are limited as BMT SMS Pacul Gowang is reluctant to expand its business beyond their locality due to a lack of human resources. In this sense, BMT SMS Pacul Gowang has not been able to use the alumni network as potential clients and human resource for its further development as has been done by BMT MMU and UGT of *Pesantren* Sidogiri, for example.

## 5. Industry development: challenges and responses

Through its strong connections with ICMI (*Ikatan Cendekiawan Muslim Indonesia, the Association of Indonesian Muslim Intellectuals*), PINBUK was active in offering assistance in the 1990s for its member BMTs. Since 2000, however, PINBUK's institutional capacity to run and supervise BMTs across Indonesia has declined. The Department of Cooperatives conducts training based on the cooperative model, but its effectiveness is questionable as it is not specifically designed for BMTs. More useful training would specifically address BMT needs and act as a venue for networking and communication among BMTs in the same region.

The BMT sector is responding to its own training needs in some cases. For example, Muamalat Institute, Baitul Maal Muamalat and BMT Center have been offering regular training to their member BMTs. Their training ranges from mental/spiritual training geared towards developing a strong and creative mindset, to sessions designed to build professional management knowledge and skills. Spiritual/mental training workshops are also offered by private business training centres which are now growing in Indonesia. This kind of training seeks to link the accumulation of capital to the moral authority of Islam and *ibadah* (religious practice). The principle can be compared to Max Weber attributing the emergence of the 'spirit of capitalism' in many European countries to devout Protestant values about work and saving. This mental training is regarded as a source of discipline for employees.

Finding additional funding sources has been a common problem for the BMT sector. To address this problem the BMT Centre established *Permodalan* (Financing) BMT Ventura in 2006 as a financial institution for its member BMTs. It actively seeks private investors in Jakarta. Related to this point, seeing the effectiveness of BMTs, the South Sumatera provincial government (*Dinas Sosial*) has been offering training and capital to establish BMTs in South Sumatera. However, interest from the local community is low because the community does not know what BMTs do. Consequently some new BMTs are operating only with government funds. Because the funds are from government, community members do not feel obliged to repay their loans.

## 6. Recommendations

The growth of BMTs as business partners for SMEs should be encouraged in Indonesia. In order to achieve this, we propose:

- BMTs should concentrate on managing loans of small value to micro and small enterprises (less than Rp 50 million). Customers requiring large amounts of money should source their finance from banks.
- BMTs should regularly conduct business/entrepreneurial training sessions for their members (e.g. *pengajian*, meetings). This will help improve the social capital necessary for further SME development in Indonesia.
- The Ministry of Cooperatives should take the lead in designing and funding capacity-building programs for BMTs by addressing their unique attributes and social mission.
- Efforts to inspire the community to actively solve problems through creative and innovative methods are still weak. We propose that the Ministry of Social Affairs and Dinas Sosial consider publishing a book on personal profiles of social entrepreneurs. Creating a prestigious award may also raise the prestige and community awareness of social enterprises.
- The Ministry of Cooperatives should compile a locality guide with profiles of BMTs and highlighting various business strategies, products and services of leading BMTs. A web

version (e-book) should also be considered to increase accessibility. As not all BMTs are prospering, the BMT sector does not have funds to undertake this.

- Dinas Koperasi and the Ministry of Cooperatives should consider advocating for a greater role for social enterprises in community development. Training sessions that teach people how to establish and run a BMT are recommended, but tighter accountability is needed. Dinas Koperasi should fund well-established BMTs that already have business training programs to provide training.
- Regional BMT associations should be formed. They should share information, and develop standard operational procedures as a step toward self-regulation.
- BMTs should utilise local knowledge and social capital to expand their businesses. The success of LPDs (*Lembaga Perkreditan Desa*, Village Credit Foundations) in Bali confirms our findings.<sup>3</sup>
- While BMTs have to ensure members' funds are secure, we also need to remember that social enterprises need public policies which permit the flexibility required by social ventures. Regulating BMTs through the existing banking laws will likely destroy BMTs' main function.
- In the short term, incorporating BMTs under the laws on cooperatives is more appropriate.<sup>4</sup> The process of revising laws should involve consultations with current BMT operators.
- In the long term, a special comprehensive law designed to meet the needs of BMTs (micro-finance, business training and *zakat* management) should be developed in consultations with all stakeholders. It should be emphasised that the recent government change to the laws on *zakat* (which aims to delegate *zakat* operations to the government) will pose threats to the baitul maal activities attached to the BMTs.

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## Notes

1. See Neni Sri Imaniyati 2008 for the first three laws mentioned here.
2. PINBUK does not supervise all the BMTs in Indonesia and many thriving BMTs in Yogyakarta do not have links with PINBUK. Consequently the data from PINBUK should be treated as one indicator only.
3. See Rosengard et al (2007).
4. This is because both BMTs and Cooperatives can offer benefit to the disadvantaged people if they can function effectively (Simmons and Birchall 2008).









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