Why is Growth of Islamic Microfinance Lower than Conventional? A Comparative Study of the Preferences and Perceptions of the Clients of Islamic and Conventional Microfinance Institutions' in Indonesia

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Whereas Indonesia has the largest Muslim country in the world with 88 % of 237 million population belonging to the faith, the growth of Islamic microfinance institutions (MFIs) has being sluggish and far behind their conventional counterparts. Islamic MFIs are struggling to survive amid the fierce competition in the provision of microfinance services, from both the conventional and Islamic. This paper will examine the factors determining the demand for microfinance services by reporting results from a survey of the perceptions and preferences of 581 MFI's borrowers from four MFIs—two Islamic (BMT and BPRS) and two conventional (BRI and BPR) in Indonesia. The results show that while the majority of MFI's clients indicates preference for Islamic MFIs, in reality their choices of MFI are based on economic (low interest rates and size of loan) and non-economic factors (such as quality of services variables easiness, speed, nearness, method and loan officers' profile). The results indicate that BRI, a conventional MFI, is ranked the most competitive according to these factors, followed by BPRS (Islamic rural banks), BPR (rural bank) and BMT (Baitul Maal wa Tamwil). The survey identifies the gaps that Islamic MFIs face to fulfill their positive roles and vehicles to reduce unemployment and poverty. As the MFIs clients prefer Islamic MFI compared to conventional, the demand for Islamic microfinance can be enhanced if the level of their economic and non-economic factors can be brought to the levels of conventional MFIs.

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

1. Background

Indonesia is the largest country with 88% of the 237 million people belonging to the Muslim faith (based on 2010 Indonesian census) and the rest of religions are Protestants, Catholics, Hindus and Buddhists. The Indonesian banking institutions are categorized into commercial and rural banks. In Feb 2011, there were 122 commercial banks and 1822 rural banks. In the latter category, Islamic rural banks only 151 with 291 total bank offices. Compared to commercial banks, rural banks are not involved directly in payment system and have restricted operational areas.

Indonesia has the greatest diversity in both conventional and Islamic microfinance model. Islamic microfinance has developed in Indonesia since 1990. However, the growth of the Islamic MFIs is sluggish and far behind the conventional MFIs (see figure 1). This

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research attempts to identify the client's preferences and perceptions toward MFI's products and institutions in order to understand why Islamic MFI grow slowly in Indonesia compared to conventional MFIs.

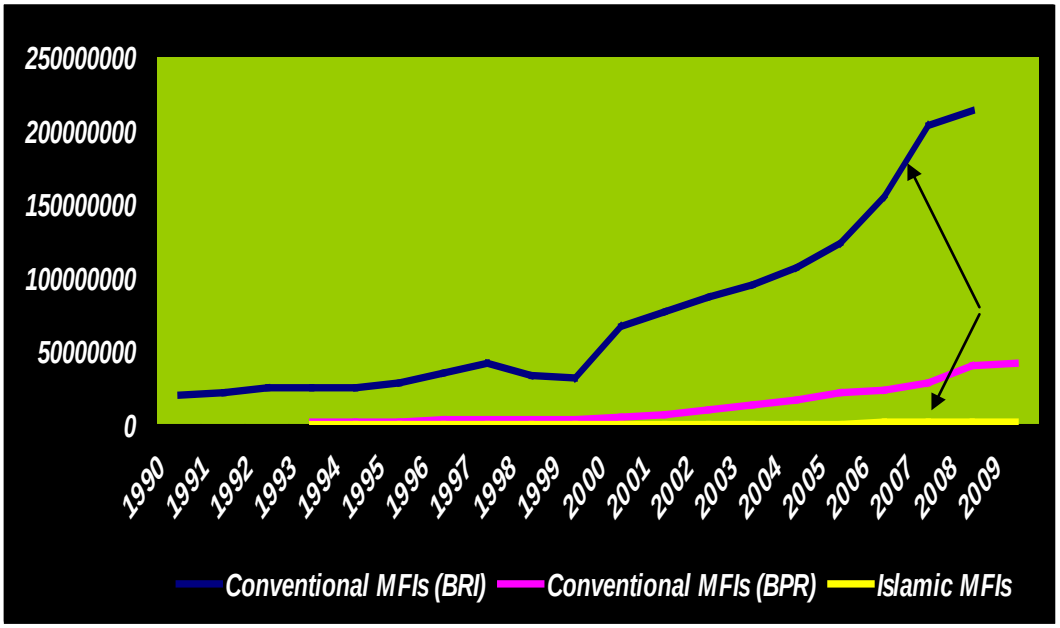

Figure 1 Gap between conventional MFIs and Islamic MFIs
(sources of data : Siebel's research, Bank of Indonesia's report, author's data processed from many resources)

Microfinance has been identified as a key instrument for poverty alleviation (Ahmed, 2004, 2007, August 2007: Chapra, 2000, 2008: Kahf, 1999: Masyita, 2005, 2007). However, there is no single microfinance's model or method that should be promoted. As Khan said that every microfinance program needs to be tailored specifically to meet complex local realities prevalent within each country or even different regions within a country. He then asserts that the needs of micro entrepreneurs, the complexity and nature of ventures to be financed are also the other reasons (Khan, 2008).

In this study, we conducted a survey to the MFIs' clients in Bandung, a city and regency in West Java province in Indonesia which has a population about 5 millions. Study includes four MFIs (two conventionals and two Islamics). Our focus on conventional and Islamic MFIs in Bandung, non-governmental institutions, includes BPR, BPRS, BMT and a governmental micro-banking, BRI that give small loan to micro and small entrepreneurs. The rest of the paper proceeds as follows: In Section 2, we outline the literature review about issues of demand sides of microfinance sectors. In Section 3, we describe the fact of microfinance (demand sides) in Indonesia. In Section 4, we provide research methodology, summary statistics of the data and analyses. Section 5, we describes the result of this research and in section 6 concludes the paper with conclusion and recommendation.

2. Demand Side of Microfinance Sector

Microfinance may be viewed as the failures of government rural credit schemes to reach small farmers (Hulme & Mosley, 1996), the failure of the formal banking sectors to fulfill low-income household needs, the failure of government strategy to cut welfare spending and diminishing the role of the state in economic development, basic healthcare, education and welfare (Fernando, 2006). Nonetheless, Hernandi de Soto in his book titled *The Mystery of Capital* (2001) highlights significance of informal business sector in a developing country's economy. In developing countries such as Indonesia, Bangladesh, Pakistan and other Islamic countries where most of the microfinance clients are Muslim, there is a need and demand to establish Islamic microfinance institutions which fulfill Muslim aspiration for *interest free* finance. To fulfill these needs, development of Islamic MFIs is inevitable.

High transaction cost is one of the key barriers to the growth of microfinance. Small amount of money per transaction and small volume in term of scale of business are the cause of high transaction cost. As the size of the loan for micro enterprise is small, the administering cost of per-unit of loan is high (Ahmed, 2007: 7 .Obaidullah & Khan, 2008: 24) and microfinance institution is riskier than a traditional financing portfolio. Therefore interest rates on microfinance are pegged relatively higher, since they entail higher administrative charges and monitoring costs.

"Easy to access, timeliness and flexibility are more important factors for micro entrepreneurs than interest rates" (Obaidullah & Khan, 2008: 24). As the MFIs grow, the savings of beneficiaries accumulate, which can then be recycled in financing micro enterprises but microfinance institutions may find it difficult to attract deposits as commercial banks do (Ahmed, 2007). There are some finance-related problems of MFIs such as asymmetric information, economic viability, low rate of ROI, debt trap, high drop-out rate and non graduation from poverty (Ahmed, 2002). Furthermore, Robinson asserts that what matters to microfinance clients is the access and cost of financial services (Robinson, 2009). Mitigate the credit risk by ensuring that micro entrepreneurs repay the principal with returns in the absence of physical collateral and reduce moral hazard problem is a part of MFI's risk management. To be viable, the costs of operations have to be kept at a minimum (Ahmed, 2007).

There are some non-finance factors which have significant impact for developing MFIs such as insufficient supervisory teams, low paid salary for officers, moral hazard, culture and specific behavior. Sufficient supervisory and monitoring team compared with the number of clients, called ratio matters, is very important to increase the repayment rate. Wages paid to field level employees can affect their incentive to work and affect recovery rates (Ahmed, 2007). Some characteristics of micro entrepreneur are illiteracy, lack of collateral, the small size of the loan, the higher administering cost of loans (assessment, processing and monitoring) which make it impossible for traditional financial institutions to offer credit to micro enterprises (Ahmed, 2002: Khan, 2008). However, based on the clients' point of view, the key words are "security, convenience, liquidity, confidentiality, access to credit, good service, and returns" (Robinson, 2009: 59) .

3. Microfinance in Indonesia

Microfinance institutions are financial intermediaries which have core businesses in financing, capital accumulation, risk mitigation, payment and remittance systems and also

provide funds for people in the bottom lines and the bottom of pyramid. In case of Indonesia's MFIs, not all people in the bottom of pyramid (i.e low income earners, micro entrepreneurs and poor inhabitants) can be served as clients. They only serve the first two group of people and very rare to serve poor inhabitants. Using the 'financial system' approach mentioned in (Robinson, 2009), it can be understood if most Indonesian's MFIs more focus to profit oriented motive rather than subsidy oriented (social motive).

A huge number of Indonesian populations, 237 million people comprise 56 million households, spreads with the composition as we can see in figure 2. Middle to high income households are target market of traditional retail banking both local and foreign banks which are very competitive markets. New target markets for microfinance/micro banking are low income and absolute poor households. The former can be approached by commercial or profit oriented motives and the latter can be approached by subsidy oriented motives which requires supporting from government or NGO. Based on Bank Indonesia household survey in 2008, Indonesian households' assets are the following;

Table 1 Indonesian Household Survey

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

Sources: Based on Bank Indonesia household survey in 2008

Table 1 shows that the percentage of households' fixed assets is 76.81%, non financial assets 15.57% and financial assets 7.62%. Whereas, Indonesian households' debt are mostly from bank 78%, non-bank 12% and others 10% with the debt servicing ratio bank 72,11% and non-bank 33,08%. Households' loan purposes are business 24%, car/motor 16%, property 14%, consumption 13%, education 8%, health 3% and others 22%. These numbers above show that there is a huge opportunity for MFIs to grow, moreover, households' repayment capacity range from 6.31% to 28.62% with debt to assets 3.78% and debt to net worth 4.03%.

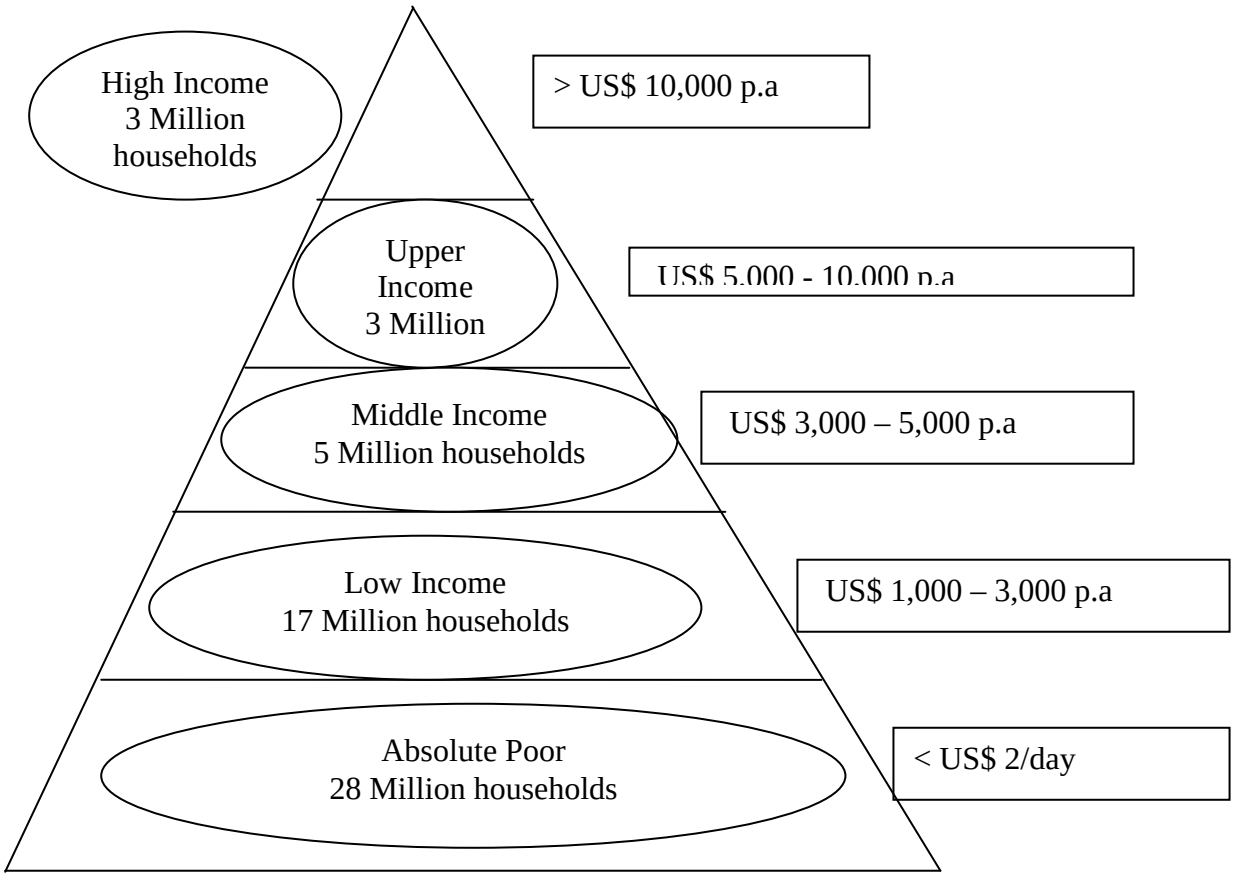

Figure 2 Sources: Asian Banker 2004 (data as of Dec 2003)

Microfinance markets are very interesting in term of profit or scale. According to CGAP's presentation, 'Making sense of Microcredit Interest Rate', the yield on gross portfolio by scale of operation are as follows; large MFIs 37,0%, medium MFIs 42,5% and small MFIs 42,8%. Therefore, four main types of financial institutions compete in microfinance sectors (Jansson, Rosales, & Westley, 2004), these includes (1) Commercial banks and other financial institutions opting for a strategy of 'downscaling'[3] , (2) Commercial banks and non-bank financial institutions specialized exclusively in microfinance, (3) cooperatives, and (4) NGO. In Indonesia, conventional rural banks (BPR) and Islamic rural banks (BPRS) can be categorized as type 2 and then Baitul Maal wa Tamwil (BMT) can be categorized as type 3. Fierce competition among microfinance providers creates the competitive cost of funds for micro entrepreneurs not only from micro finance institutions such as BPR, BPRS, cooperative, BMT but also from the large banks with their micro banking division. The latter include local banks such as BRI, Andara, Mandiri, Mega, Mayapada, BTPN and foreign banks such as Citibank, Danamon and HSBC. These large banks with their micro banking division can be categorized as type 1. However, BRI, a state commercial bank which is fully supported by Indonesian government, is a dominant player. In practice, there are two strategies of the big banks in developing micro banking, directly dealing with the micro clients and indirectly reaching the clients but through other MFIs (via linkage program).

3.1 Types of Microfinance in Indonesia

In Indonesia, the first were established as microfinance institution was rural banks, mostly in the village areas. The first rural bank was established in 1895. Bank Rakyat

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

Indonesia (BRI), a stated owned bank, established in 1984 and rural banks, BPR (Badan Perkreditan Rakyat), established in 1988. In particular after Asian financial crisis in which many big companies collapsed and left a huge amount of debt in the banking sectors. At the same time the SMEs survived and mostly could manage their debt well. Since that time, banking sectors have put more of their investment portfolio to the SMEs and some of them actively got involved in microfinance. This also was triggered by Bank Indonesia which was actively promoting MSMEs and then encouraged the big commercial banks to enlarge their lending to MSMEs. Commercial banks took this opportunity which opened 'micro-service units' in early 2003. It is quite unfair for BPRs in term of scale of economy and regulation. However, the potential of the micro credit market is still big[4]. Not only have banking sectors which have enthusiastically played in microfinance market, the Pegadaian (pawnshops) as a state-owned company have special privileges regulated by law have also aggressively taken part.

According to Ismawan and Budiantoro (2005), in Indonesia microfinance approaches can be categorized into 4 kinds: saving led microfinance, credit led microfinance, micro banking and linkage model (Ismawan & Budiantoro, 2005). In a saving led microfinance, membership and active participation are pivotal. In this type, financial mobilization is based on capacity of the poor and membership based. Self-help groups (SHGs), Credit Union (CU), and *Koperasi Simpan Pinjam/KSP* (savings and credit cooperative) are some kinds of institutions within the societies. In a credit led microfinance, the key resource of finance is not from saving mobilization of the poor but from other resource intended for the poor. In a micro banking, BRI and BPR (rural banks) are example of banks designed to conduct micro finance services.

Linkage model generated by central bank, Bank Indonesia, is a starting point of collaborative between commercial bank and BPR since 2000. The two different characters and natures of institutions, commercial bank have huge capital and BPRs have longer experience dealing with micro entrepreneurs, are organized and linked based on mutual symbiosis and benefits. BPR which lack funds but more access to the poor can get access to *financial support* while commercial banks which have more funds will get greater number of clients (*outreaching*). Supported by Bank Indonesia, this collaboration is widely well-known as *Pola Hubungan Bank dan Kelompok Swadaya Masyarakat/ PHBK* (Bank-Self-Help Groups Linkage) in 1988.

Directorate of syariah Bank, Bank Indonesia (BI) implements a comprehensive linkage model for Islamic microfinance. This linkage model foresees three types of intervention: "for-profit financial assistance, not-for-profit financial assistance and technical assistance for developing micro-enterprises. Islamic commercial banks are the ones which get for-profit financial assistance for either their own division or jointly with the rural banks (BPRS) and/or BMTs" (Obaidullah, 2008: 79-80). Bank of Indonesia attempts to promote a non-profit-financial assistance which is provided by Islamic commercial banks in the form of *zakah, infaq, sadaqa* and *waqf*. Directorate of Sharia'ah Bank BI encourages these Islamic voluntary funds are utilized to fulfill basic consumption needs of the poor and to provide the training for un-skill micro- entrepreneurs and start-up capital for micro-entrepreneurs. But at that moment, using Islamic voluntary funds gathered by Islamic banks is still not yet possible in term of fund sufficiency and regulations. Therefore, for starting this initiative, Bank Indonesia provides the technical assistance funds to various business development services providers and consultants in collaboration with universities in Indonesia. For example, during 2006-2008, Bank Indonesia collaborated with Lembaga Manajemen Fakultas Ekonomi (LMFE), a Management

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

Studies Centre, University of Padjadjaran Bandung conducted a pilot project of Shari'ah linkage for Islamic microfinance institutions in West Java and Yogyakarta Provinces. LMFE conducted the research and gave treatments (spiritual, technical and managerial) for micro-entrepreneurs who got the micro financing from Islamic rural banks (Masyita *et al.*, 2011).

3.1.1 Conventional MFIs

3.1.1.1 Bank Rakyat Indonesia (BRI) Microbanking

BRI, one of largest and oldest tradition of MFI in this world, started in 1895 with the name - the first rural bank – Bank for Civil Servants. BRI, a conventional MFI, is a state bank and since 2008 has been the best bank based on credit rating. BRI is a biggest five MFIs in the world (Microcredit Year, 2005) in terms of clients and their loans. Bank BRI provided services such are loan products, savings products, insurance, and money transfer services/remittances. BRI can be categorized as commercial banks which play in the market with small amount of money per transaction but massive volume amid hundred million Indonesia people who live in the rural areas. With maximum amount of USD 500 (Rp 5 Million) and maximum tenor of 2 years, BRI units also have a non collateralized loan for the lower-income clients. BRI is also based on individual-liability loans which can be explained with high repayment performance than social networks among borrowers.

Many lessons can be learnt from Bank Rakyat Indonesia (BRI). A pre-existing relationship within communities and by using the testimony of a respected community figure as social collateral on the borrower's loan are some reasons of BRI's success ingredients (Robinson 1992; 1994). Therefore, the group-lending scheme has proven less successful in Indonesia. According to Don Johnston, "The main clients of BRI are petty traders or owners of small enterprises like restaurants and tailor shop, typically making high margin, quick turnaround investment who have capabilities to pay real interest rate" (Morduch, 2009: 18) "BRI's scheme had developed product that have enabled it to work profitably with low-income households and it is more convenient for bank clients" (Arun, Hulme, Matin, & Rutherford, 2009: 11). As a profit making enterprise, BRI's efficiency can be achieved through transfer prices in subsidized programs. "Transfer prices are the internal prices used by institutions to value capital and determine relative performance at branch levels"(Morduch, 2009: 27). A research was conducted by Chaves and Gonzales-Vega explains that system monitoring; managerial discretion over transactions conducted at market terms, policies to protect portfolio value, and no dependency-creating subsidies, compatible incentives such as performance based compensations (profit sharing, collection fees) and efficiency wages are the essential factors of MFI's mechanism design (Chaves & Gonzales-Vega, 1996). They also found that networks of semiautonomous units, which are the advantages of BRI Units, use local information and mechanism of contract enforcement lower the transaction costs.

Bank BRI Units savings products are based on principles of trust, security, convenience, liquidity, privacy, linkages with loans and returns (*Microfinance Industry Reports - Indonesia*, 2009: 11). According to Robinson (2009), for sustaining in the long-term basis, "competing institutions requires a financial approach" and BRI have showed that it can still reached the active poor clients.

3.1.1.2 BPR (Badan Perkreditan Rakyat)/ Rural Credit Banks

In 19th century, during Dutch colony in Indonesia, the rural credit banks were established, namely Lumbung Desa, Bank Desa, Bank Tani, and Bank Dagang Desa. The main objective

of these banks was to protect the labors fall into the trap of the high interest rate from the moneylenders. In the beginning 1970s, Lembaga Dana Kredit Pedesaan (rural credit fund institutions) were established by the local government. Subsidized credit to SMEs has been practiced since the 1970s. In 1988, Presiden Republic of Indonesia decreed Paket Kebijakan (Policy package) Oktober 1988 (PAKTO 1988) through President's decision no.38. This decree provided the momentum to establish rural credit banks.

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

BPR is a financial intermediary institution for lower-income people and the poor which regulated by law and supervised by central bank. Target markets of BPR are mostly rural and suburban people who are untouchable by large commercial banks. Easy access and simple administrative procedure for simple villagers are the BPR's characteristics. Mostly are located close to market (rural population and small business) and BPRs focus on people's unique needs in that particular area. As a supervisor of BPR, Bank Indonesia has been facilitating linkages between commercial banks and BPR

From 2001 to July 2006, there had been dismissed 249 BPRs and merged the 306 BPRs into 26 BPRs (post merger). 95% of merged BPRs were owned by local government. Nevertheless, during the crisis, the proportion of bankrupt of BPRs was lower than the proportion of bankrupt commercial banks. There is a challenge for BPR, the government encourages the big private and owned-state companies to share a few portions of their profit to finance SMEs. Therefore, through their Corporate Social Responsibility/CSR program, private and state-owned corporations prefer direct lending to MSMEs, instead of using BPR. Gaining political advantages as being "good neighbors" to surrounding SMEs is one of the reasons behind direct lending (credit) with low interest rate (6% interest rate flat) meanwhile, BPR provides credit with an interest rate of 30% per annum. For example, the biggest companies in Indonesia, Telkom, Pertamina, Krakatau Steel, Indonesia Harbor and other stated-owned companies disbursed revolving soft loans at 6% p.a. As the result, it is quite difficult for BPR to compete with the big state-owned corporations in term of interest rate of credit in the particular areas in Indonesia.

3.1.2 Islamic Microfinance Institutions

Bank of Indonesia as a legal institution to regulate and develop banking in Indonesia have been mandated by the constitution through Act 10 of 1998 and Act 23 of 1999 to develop Islamic banking in Indonesia including Islamic microfinance institutions through BPRS. Islamic MFIs are established based on partnership concept with jointly share the profit and risks. Based on revenue-sharing, clients transfer the fund to the bank. On the asset side, the bank transfers the fund to the clients based on profit-sharing, Islamic MFI finances only real transactions with the underlying assets. Lending or financing is backed by collateral. Therefore, to minimize the risk the well-performed existing clients only who are financed.

Unfortunately, the journey towards the development of Islamic microfinance has not smooth running. In fact, the reality and the expectation are not the same sometimes.

3.1.2.1 Bank Pembiayaan Rakyat Syariah (BPRS)/Islamic Rural Bank

Bank Pembiayaan Rakyat Syariah (BPRS) is regulated by National Act No.7/1992 and then amended into National Act No.10/1998 (*Peraturan Bank Indonesia tentang Badan Perkreditan Rakyat*, 2004: 3). BPRS is supervised by the central bank, Bank Indonesia. BPRS were first established in 1991, as a result of decision of *Majelis Ulama Indonesia* on the prohibition of Riba. Afterward, a technical team was formed and steps were taken to established Islamic commercial and rural banks"

Seibel and Agung's (2005) maintain that there was no significant effect of fatwa on the preference of Indonesian Muslim toward the Islamic banking system. The historical data shows that conventional (BPR) and Islamic rural banks (BPRS) have developed over a similar time span but the Islamic rural banks are far behind the conventional counterparts. Conventional rural banks (BPR) started since 1989 and Islamic rural banks (BPRS) began operations since 1991.

Seibel and Agung (2005) state that conventional rural banks have thus grown more than 20 times faster than Islamic rural banks on a yearly basis. After a promising start in the early 1990s, the development of Islamic micro-banks has almost come to a standstill. An initial period of growth until 1996 when they reached a total of 71, their number almost stagnated during and after the financial crisis, reaching 78 by 1998 and a mere 84 by 2003 (out of a total of 2,134 rural banks), and 92 by December 2005. The first Islamic cooperative was established in 1990. Rapid expansion started after 1996, as a result of promotion by Center for Micro Enterprise Incubation (PINBUK), a non-government organization, and continued throughout the financial crisis, but stagnated after 1999 at around 3,000 and then declined to less than 2,900 as of 2003 (out of a total of some 40,000 microfinance cooperatives) (Seibel, 2008: 90).

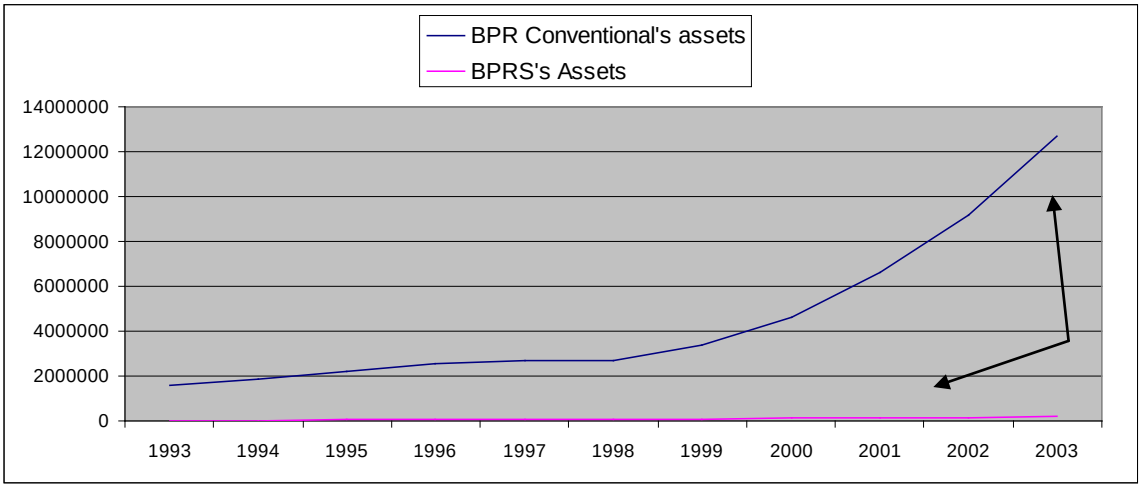

Figure 3 The differences between BPR (conventional) and BPRS (Islamic) Assets

3.1.2.2 Baitul Maal wa Tamwil (BMT)

Fast growing microfinance institutions and fully supported politically and socio-religiously by the government and the grass root make Baitul Maal wat Tamwil (BMT) survive with a new approach to serve the grass root segment by implementing a *Shari'a* system. BMT is an Islamic cooperative. Beyond the reach of Bank Indonesia, these BMTs have grown rapidly in the aftermath of the banking crisis, reaching more than 3,000 units.

The development of Islamic banking has been paralleled by that of Islamic financial cooperatives, or BMT. The first Islamic cooperative, Ridho Gusti, was established in 1990 in Bandung. Nadhatul Ulama (NU), the largest Islamic mass organization in Indonesia with has almost 40 million members, initiated BMT (*Baitul Maal wat Tamwil)* which comprise of 95% of Islamic cooperatives. On the other hand, Muhamadiyah, the second-largest Islamic mass organization in Indonesia with 25 million members established BTM *Baitul Tamwil Muhamadiyah* which comprises of 5% of Islamic cooperatives. It should be noted that statistics on BMT usually include the BTM (unless otherwise stated). BTM are informally supervised by PPEM (Seibel & Agung, August 2005).

The Ministry of Cooperatives does not register cooperatives as Islamic or conventional and provides no information or special assistance to Islamic cooperatives. In sum, the outreach of Islamic cooperatives was negligible, and then, their overall performances were poor. Some facts about BMT are lack of regulation, supervision and reliable reporting, large majority of Islamic cooperatives are dormant or technically bankrupt, the savings of the depositors are at great risk (Seibel, 2008).

4. Research Methodology

To study the relative perceptions and preferences of conventional and Islamic MFI's clients, survey was conducted in 2010. There were 28 BPRs, 17 BPRS, 64 BRI Units and 8 BMTs in Bandung. However, Bandung is one of hundreds cities in Indonesia and Bandung can not represent the characteristics of Indonesian as general but at least almost all of tribes in Indonesia can be found in Bandung. People who live in Bandung are multi cultures and education backgrounds. Bandung has a highest density of population in Indonesia. More than thousand of micro small medium enterprises underpin Bandung as a tourist destination and an education city in Indonesia. The second reason why we choose only Bandung as research population, because Indonesia is a big country with about 237.6 million populations spreading in more than 17,000 islands with three time zones. It is very difficult for us to conduct a survey with scope of research cover Indonesia as general due to limited cost, time and personnel. The third reason, the researcher was familiar with Bandung and has lived there for more than 20 years. The researcher actually recognized and extremely familiar the specific character of people, cultures, the way of life, dynamics environment and other information are needed to produce an appropriate investigation. We hope based on this background make our judgments more comprehensive in considering varieties of variables.

The aim of this study is to investigate the huge gap between conventional and Islamic MFI growth based on MFI's perceptions and preferences. The objectives of this study are (1) to identify the profile of MFI's clients, (2) to explore MFI's clients' perceptions, (3) to explore the preferences of MFI's client, and (4) to identify the reasons behind choosing a MFI. Based on the dispersion of MFIs clients in a large area in Bandung, we used multi-stage cluster sampling. The researcher with four surveyors divided the area into six clusters, and we

interviewed 100 randomly selected MFIs clients at each area. In this research, probability sampling designs are preferred because such designs give each MFI's client chance of being selected. The list of the MFI's clients has been given by MFI officers to the researcher. Based on those data, the interviewers selected them randomly. In the field, this technique is hard to apply because many reasons such as respondent's reluctance to be interviewed, the difficulty to arrange a meeting time, and consume more money and time. In the beginning, the respondents are chosen randomly based on the list and after one month the surveyors visited the respondents in the traditional markets which spreading across the city. Most traders in traditional markets are MFI's clients. The other places where it is quite easy to find the MFI's clients are government institutions. It is common that an institution has collaboration with a MFI. However, this kind of collaboration reduces risk for MFI because the monthly credit payment directly debited from clients' monthly salary.

The result of survey provides empirical data of clients' profiles, perceptions, preferences MFI's clients and their reasons to choose a MFI. This survey examine the profile of MFIs clients either conventional or Islamic MFIs, based on the answers to questionnaires that were sent to 650 MFIs clients in Bandung. Data on the general profile such as the gender, age, job and knowledge were sought. Furthermore, data which are highly related to client's history in term of size of loan, frequency of loan, interest rate are also provided in order to support the analysis. Perceptions, preferences and reasons of MFI clients are also provided afterwards. From 650 sent questionnaires, 603 MFIs clients responded and fulfilled the questionnaires and finally only 581 questionnaires are appropriate and complete to be processed statistically.

5. Results

5.1 Profile of Microfinance Clients

In our sample in table 2, the proportion of male (56%) is bigger than female (44%) but our sample in BRI shows otherwise female is much more than man.

Tabel 2 Gender of MFIs

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

The majority of the MFI clients' ages range is between 30 – 41 years old (56.5%), is followed by clients who have age between 42-52 years old (28.5%), younger and up to 30 years old (13%) and only 2% of the sample who have age older than 53 years old (see table 3).

Tabel 3 Age of MFI's clients

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

MFIs tend to give a loan to the productive ages client especially by BMT, BPR and BPRS. There is a sensible reason to give a loan to the productive age clients more than other group ages. However, microfinance sector is assumed that it has more risk compared to the banking sector as general in term of collateral and nature of micro business. But it is completely different with BRI in which the proportion of group 30-41 years old almost equal with the group 42-52 years old. This fact can be explained by data regarding the job of MFI's clients that BRI clients mostly are the permanent employees either government or private sectors. For client who has permanent jobs, range of age between 31 and 52 does not make any differences. They can pay the loan from their permanent salary. BRI can give a client the lower interest rate as long as the government or company offices have a mutual of understanding (MoU) with BRI before. Hence, BRI has demanded a guarantee from government officials or company that every month the salary of clients goes to loan payment directly. This is the power of BRI as a state bank and also the advantage of BRI to win the fierce competitions among MFIs in Indonesia.

Tabel 4 Jobs of MFI's Clients

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

In table 4 shows that the majority of client jobs are not government (19%) or private company employee (38%) but others (43%) such as pretty traders, micro entrepreneurs, peasants and etc. It is very clear that BMT, BPR and BPRS do not choose the government employees as their target market. They played in the high risk market but potential highly return. Government employees are BRI's target market which has characteristics; fixed income, the lowest risk (almost zero because the monthly salary goes directly to BRI account), low cost (officially almost zero cost because BRI had a MOU with the government/company before but potentially can be a practice of collusion between them which is hardly proved).

Tabel 5 Duration of MFI's Loan

	MFI	Duration of MFI's Loan (year)					
		< 1	1-2	2-3	3-4	4-5	> 5
MFI's Clients	BMT	59	17	14	7	9	1
	BPR	115	17	4	0	4	3
	BPRS	51	42	25	1	1	3
	BRI	65	30	34	7	50	19
Total		290 (50%)	106 (18.5%)	77 (13.5%)	15 (2.5%)	64 (11%)	26 (4.5%)

Regarding loan history, the majority of loan duration is less than one year (50%), is followed by duration between 1-2 years (18.5%), 2-3 years (13.5%), 4-5 years (11%), more than 5 years (4.5 %) and 3-4 years (2.5%) respectively (see table 5). Short loan is a majority type of BMT and BPR. Short loan means the client need a loan for emergency or consumption need. It is quite not reasonable to build a robust small business in a year or less and show the results or profit in the short period. BPRS and BRI gave loan more proportional in term of duration. Duration of loan also effects to the cost of loan as its consequences.

Tabel 6 Size of MFI's Loan (million Rp)

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

There are various sizes of loan of MFI's clients. The most size of loan is between Rp 1 million (US$ 100) – Rp 3 million (US$ 300) (29.5%) and the least loan is Rp 100 million (US $10,000) only 1%. BMT focuses its loan between Rp 1 and 3 million (US$100 - US$300). BPR focuses its loan between Rp 1 and 5 million (US$100 - US$500). BPRS focuses its loan between Rp 1 and 10 million (US$100 - US$1,000). BRI provides long range of loan from less than Rp 1 million to more than Rp 100 million (<US$100 – > US$10,000). According to a staff of BRI in an interview, BRI has unlimited fund to be borrowed as long as the clients fulfill all the prerequisites and pass the screening application process. BRI unit officer can ask unlimited amount of money to BRI banking headquarters if there is a potential customer in his/her unit. That is another advantage of BRI compared to other MFIs.

Table 7 Frequency of Loan

	BPR	BPRS	BMT	BRI	Total
Once	121	75	52	90	338 (56%)
twice	9	17	22	46	94 (15.6%)
three times	6	12	16	28	62 (10.3%)
four times	4	13	13	29	59 (10%)
more than four times	14	6	14	15	49 (8.1%)
total	154	123	117	208	602 (100%)

Table 7 above shows that only 8.1% of clients received loans more than four times, 10% of clients received loan four times, 10.3% of MFI's clients in this survey received loan three times, 15.6% of clients received loan twice and 56% of clients received the loan once. Most of the first-time client got a loan from BPR. This was followed by BRI, BPRS and BMT respectively. Only a small number of clients who got repeated loan from MFIs. Many lessons can be learned from this fact. First, it was quite easy for a client to convince the loan officer to give them a loan for the first time or at the same time, loan officers tried to fulfill their marketing target as much as they can to get new clients. Second, after evaluating the first loan period, it was only a small number of clients who deserved to get the next loan. When these phenomena were asked to the loan officer, most of them said that it was very difficult to get a good client who had a sustainable business especially small or micro business.

They, then, said that most MFI's client borrowed the money only for consumption purposes or emergency needs although along the interview process the clients claimed to use the money for working capital or buying fixed assets to support their business. BPR had collaborated with the highest risk clients and then as a consequence of that, BPR charged the borrowers/clients higher interest rate for return. BRI, BPRS and BMT also show the same pattern with BPR but in lower and moderately scales. BRI shows a relatively stabile pattern.

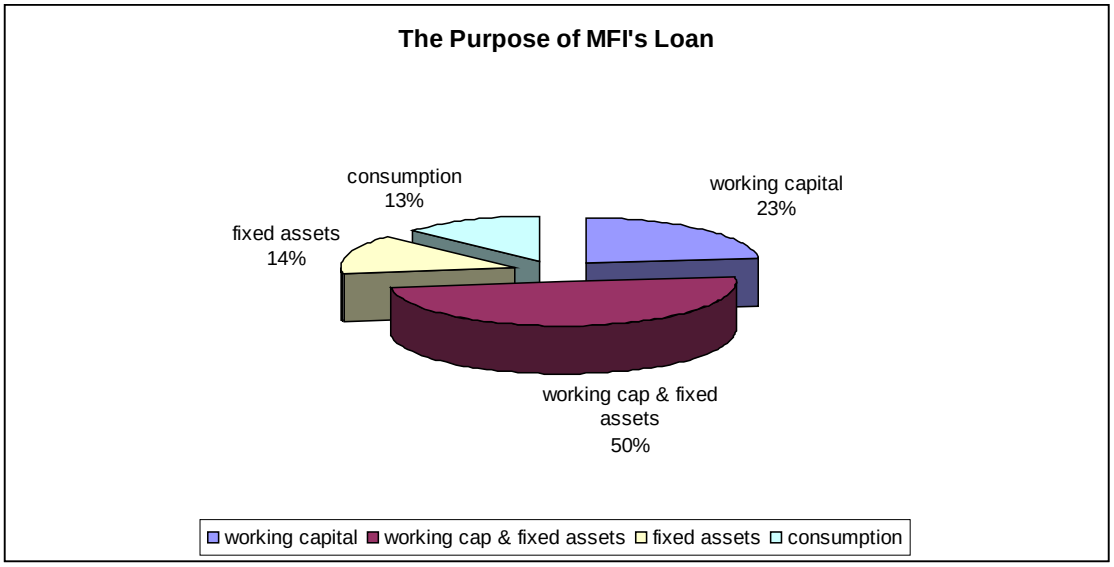

Figure 4. The Purpose of MFI's Loan

When MFI's clients are asked about the purpose of their loan (see Figure 4 above), 50% of them answered that their loan purposes are for working capital and fixed assets, 23 % of client stated for working capital only, 14% of client stated for buying fixed assets and 13% of them used the loan for consumption purposes. In reality, when the researcher interviews the clients about the real purpose of the loan, most of them said they needed the loan for emergency (covered hospital cost for family member, admission school payment for kids, other debt payments, etc) and consumption (as a down payment for a motorcycle, a new TV, hand phone, etc). If they wrote 'working capital or fixed assets' purposes on the application form, it was just for an administration purposes only. The main reason to do that was to get a loan as soon as possible with putting a document which can be an education certificates, estate ownership document, car/motor ownership certificate, employment status document or other valuable documents as its collateral. Without putting clear collateral, it was quite impossible to get a loan.

Table 8.The average of Interest rate/cost of fund

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

Table 8 above demonstrates the average of MFI's interest rate. Actually, there are varies interest rate from one MFI to other MFIs in Bandung and in some cases varies among clients in one MFI as well. This figure was obtained based on the answers of MFI client in the fieldwork toward our questionnaires. The surveyors asked the client how much money they have to pay for monthly payment of their debt and their loan period. The fierce competition of MFI in Bandung created a price war among MFIs particularly BPRs, BPRS', BMTs and other forms of cooperative but they still can not beat BRI's interest rate as the lowest rate ever. BRI is a state bank and fully supported by Indonesian government with many cross subsidy programs. Table above explains that BPR, BPRS and BMT must compete each other to attract new potential clients and also still maintain existing clients who have good track record. During an interview, the loan officers told the surveyors that in some cases sometimes an unethical officer tried to persuade prospective clients who have registered in other MFI in order to close their loan from the existing MFI and then move to his/her MFI for some interesting offerings such as a cheaper, bigger size and new payment scheme for their loan. During an interview, a director of BPRS also told us that a few months ago she lost the prospective group of clients who have been approached for 5 months because her colleague from other MFI knew about this information and hijacked them hostility in order to fulfill his annual target as a marketer.

Highly varies of interest rate among BPRs can be explained with some facts in the field that short term orientation of loan officers became a strategy to meet their own annual target as long as the clients have something valuable to be guaranteed as collateral. Loan officer or marketer's target in term of number of clients or amount of money greatly related with commissions and other performance indicators which are pivotal for loan officer in order to maintain or move forward in his/her career. High interest rate is applied by BPR as a consequence of high risk involved. Differ from BPR, BRI applies the moderate or even lowest interest rate as a consequence dealing with the low risk clients and also because of cross subsidy programs from Indonesia government. BPR and BRI are conventional MFI but they represent the opposite pole of the battle. On the other hand, represented Islamic MFIs, BPRS and BMT's positions, are lying in the middle between two giant-conventional players, BPR and BRI. BPRS and BMT have set Muslims as target market with offering Islamic finance products such as *murabahah, musharakah, ijarah, rahn* and other Islamic finance services to the market. The cost-plus (*murabahah*) transaction rate if it was considered equivalent to interest rate (for benchmark purpose only), then seem that BPRS and BMT are quite moderate in term of risk and return. However, Bank Indonesia, a central bank, regulates the policy which make MFI under its supervisor have to maintain non performance loan (NPL) at least 5% overall. This policy is very useful as an early warning system for MFI in order to avoid the factors which will jeopardize a MFI in the future. Akin to other commercial banking, Bank Indonesia as a regulator also applies a prudent microfinance institution for MFIs under

its supervisory (BRI, BPR and BPRS only), the other hand, BMT is supervised under Ministry of Cooperative.

5.2 Clients' Understanding Towards Islamic Microfinance Products

We conducted a survey about the clients' understanding of the Islamic microfinance products. As general, the majority of MFI's clients did not understand about Islamic banking or microfinance products as we see in table 9 below.

Tabel 9 Understanding of Islamic Banking Products

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

Murabahah concept is the most popular and familiar for MFIs' clients. Nonetheless, it was only understood by 26.85% of clients. BPR and BPR, conventional MFIs, show a huge gap of number between the clients who understood and the clients who did not. It was totally different from BPRS and BMT whereas both of these Islamic MFIs have almost equal number between the clients who understood and the clients who did not. 80.72 % of respondents did not understand about *Mudharabah* concept. Only BMT shows almost equal balance between respondent who understood and did not understand. Akin to two Islamic banking products above, *Musharakah* shows the same pattern with the previous products. BMT demonstrates slightly different number between the clients who understood and who did not. For *Ijarah*

product, only small number of clients who understood about this concept, most of them did not recognize it as an Islamic banking product.

Lack of understanding about Islamic banking product can be understood as we see the fact in the table 10 regarding the training sessions that the clients had received before.

Table 10 Training per MFI's Type

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

Based on survey, the majority of sample never received training during loan periods (68.85%) and only 31.15% of MFI's clients received training sessions. Data in table 10 above also show that only small number of BRI, BPR and BPRS's clients, as general, who received training. Despite the fact, it was quite amazed that the majority of BMT's clients had received training (56%). For those who received training, only 17% clients have received spiritual training, 12% and 3% have received management and technological training respectively (see figure 5 below).

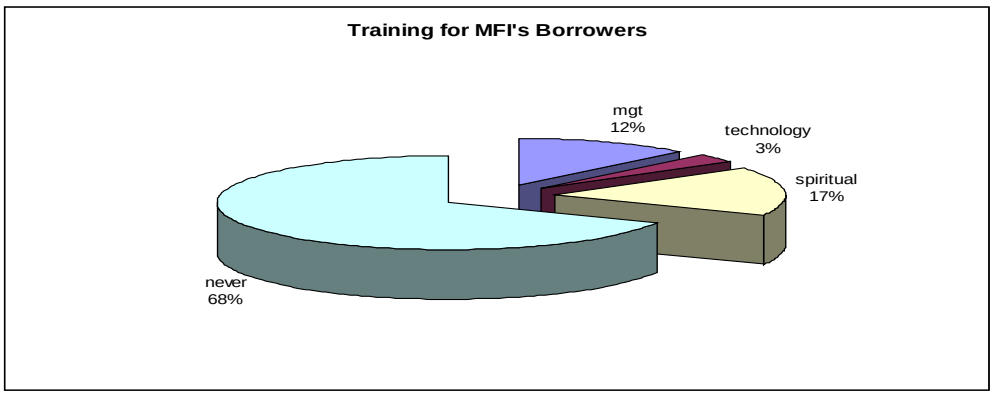

Figure 5 Training for MFI's Clients

There was no specific training regarding the introduction of Islamic Microfinance products provided by Islamic MFIs. Therefore, having high expectation for Islamic microfinance clients to understand the differences between Islamic microfinance products and conventional is such a dream.

5.3 Clients' Perception to Their Relative Interest Paid

In table 8 above, we can see the average of interest rate/ cost of fund among MFIs. BRI in average was the lowest interest rate, followed by BPRS, BMT and BPR came the second, third and fourth lowest respectively. Interestingly, when surveyor asked clients' perception about the rate of their interest rate compared to other MFIs, 48.4% clients felt his/her MFI's rate equal to other MFIs, 46.3% clients perceived her/his interest rate lower than other MFIs and only 5.3% who said that his/her interest rate higher than others (see Tabel 11 below). But actually, their interest rate was much higher than their perception. It sounds that they tried to

convince themselves that they had selected the cheaper and right MFI. In brief, client's perception about interest rate/cost plus in *Murabahah* transaction in average was lower or equal than actual rate.

Tabel 11 Perception of Relative Interest Rate Paid per different MFI

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

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

5.4 Clients Preferences for Conventional or Islamic MFI

Regarding MFI's client preference for choosing whether conventional or Islamic MFI, table 12 shows the interesting phenomena where 54.4% of respondents preferred Islamic MFI rather than conventional MFI (45.6%), though the majority of respondents are conventional clients. When surveyors asked deeper to the clients about the reason behind this, most clients answered that using Islamic products as a Muslim create the tranquility, peace and confidence. But at the end the practicality and economical reasons are on top of everything. For further facts about those reasons can be seen in table 13 below.

Tabel 12 Preferences of MFI's Clients

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

It was fully reasonable if BMT's (Islamic MFI) clients preferred to choose Islamic MFI and also made sense if BPR's (conventional MFI) clients preferred conventional MFI. If there were 28.5% BPRS (Islamic MFI) clients who preferred conventional MFI, this fact seems quite perplexed. This fact raised a big question. It was also the case for BRI's (conventional MFI) clients who preferred Islamic MFIs rather than conventional MFIs although they were completely aware that BRI is a conventional MFI. The proportion of BRI's (conventional MFI) clients between who preferred Islamic and conventional MFI was almost equal.

The findings whereas conventional MFI's clients preferred an Islamic MFI and otherwise, Islamic MFI's clients preferred a conventional MFI stimulate the big questions. Prefer one thing and choose the other thing is an inconsistent behavior.

One of few possible explanations is their unconscious (or conscious) loyalty towards the moral/ethical Quranic world view of choosing a banking and finance institution. However the reality on the ground is that the Quranic principles, within it the interconnectedness with other human conduct and its vision (the Quranic vision of society), has not realized on practical level yet. It is possible to even argue that this type of behaviour is natural. Frankly to say that in practical level there is no reality to the Quranic world view (and therefore they turn to practical use of conventional economics) but in an idealism level they remain loyal to the Quranic teachings.

What the other reasons behind these preferences and decisions? What the drive such a behavior? The next sub section can be expected to answer the questions above.

5.5 The Reason of Clients in Choosing a MFI

In order to dig deeper the reasons behind their decision to choose a MFI, surveyors asked MFI's client to tell the reasons. They came up with the most eight reasons; nearness, easiness, low interest/cost of fund, speed/fast, low collateral, size of loan, payment methods and profile of loan officers. They were also asked to rank those reasons according to their priorities.

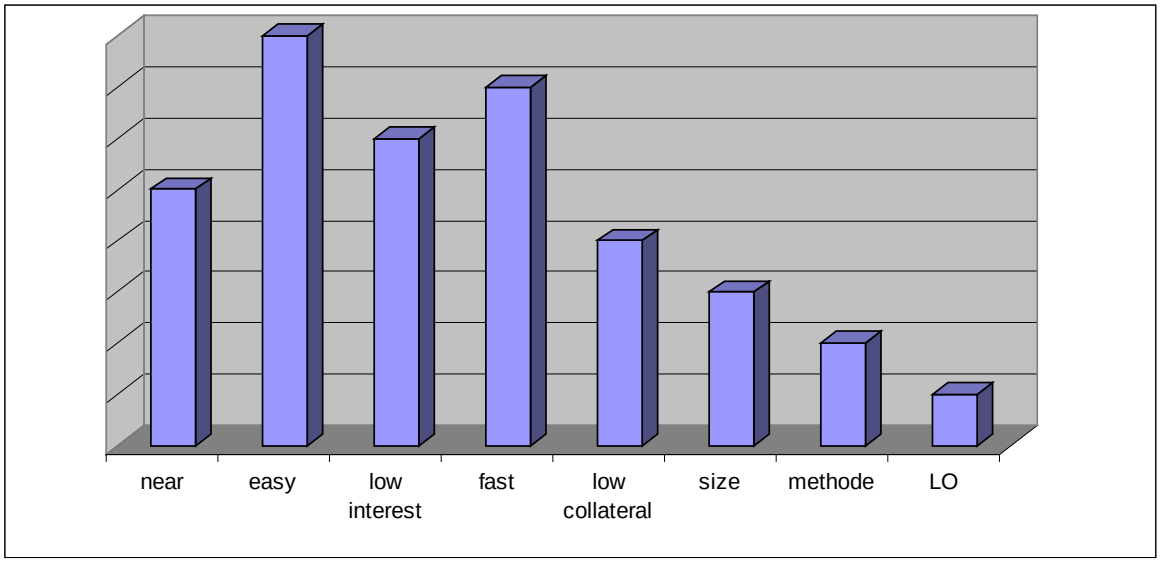

Figure 6 Reasons in choosing a MFI

Figure 6 above shows that the easiness in process was the first priority to choose a MFI, followed by fast/speed, low interest rate, nearness, low collateral, size of loan, payment methods and profile of LO which came second, third and up to eight respectively. Some non economy factors such as easiness, fast/speed and nearness were more prioritized by clients compared to economy factors such as low interest, low collateral and size of loan. In many interview opportunities, surveyor got an impression that rational choice in term of management issues and economy reasons was the main reason in choosing a MFI and religious reason came afterward.

This finding turns up many implications in understanding Indonesian Muslim behavior towards *muamalah* and spiritual aspects. Nevertheless, Indonesia is not an Islamic country, even as a largest Muslim population in the world. Indonesian Muslims live in an increasingly secular society, in which religion has less and less influence on their daily lives. In economic live, rational choice based on the rational economic behaviour perspective is dominant in decision making process either consciously or subconsciously. But in other reality, when respondents were asked about their preferences towards their choice for Islamic products or conventional, the majority preferred Islamic MFIs.

5.5.1 MFI's Clients Rankings

Respondents were also asked to rank MFIs based on the categories below. As we mentioned earlier, MFIs in Bandung face a fierce competition and clients have the rights and wide opportunity to choose a MFI that suits his/her needs. Therefore, the majority of them know well the other MFI reputations and each interest rate. They used to compare each other before deciding a MFI.

Table 13 Ranking of MFIs based on MFI's Clients perspectives

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

Table 13 shows the rating for each BMT from 581 respondents. The results are BMT as the winner for Islamic compliant, and BPR for fast/speed category. The rest of categories left BRI as a winner. BRI is well known as a MFI with easiness, good process of application, low interest rates, low collateral, appropriate payment methods, excellent relationship of loan officers and most preferable MFI.

6. Conclusions

Based on empirical data above, it can be concluded that BRI as a conventional MFI became MFI's clients' favorite. The empirical data clearly show that a huge gap among BRI, BPR, BPRS and BMT can be explained through many factors either economic or non economic factor involved. Although most of clients were Muslim and they preferred to choose Islamic MFIs, in reality their choices of MFI were based on economic (low interest rates, low collateral and size of loan) and non-economic factors (such as quality of services variables easiness, speed, nearness, method and loan officers' profile).

There was inconsistency behavior whereas conventional MFI's clients preferred an Islamic MFI and otherwise, Islamic MFI's clients preferred a conventional MFI. Prefer one thing and choose the other thing is an inconsistent behavior.

The Islamic banking and finance actors in Indonesia face this kind of behavior in daily basis. Dealing with these issues is not an easy task. Their unconscious (or conscious) loyalty is towards the moral/ethical Quranic world view of the transaction of economy as their idealism. However, the reality on the ground is that the quranic principles in a daily life have within it the interconnectedness with other human conduct but its vision (that is the Quranic vision of society) is not realized on practical level yet. Based on these findings, they showed us that, at least, if the Islamic microfinance institutions provide the same level of quality in product and services with the conventional one, it can be presumable that the majority of Muslims clients will shift from the conventional microfinance clients to Islamic microfinance clients.

BRI as a state bank has the robust structure, special privileged from government, long life experienced, cheaper source of fund and the most important is scale of economies make it the primary source of loan for clients. As long as the existing banking regulation does not change, it is quite impossible for BPR, BPRS, and BMT get a chance to grow significantly in the future. However, from clients' point of view, regardless whatever MFI, clients always get the benefit with cheaper cost of fund from BRI. Moreover, these MFIs inevitably must compete with the big commercial banks which have widely opened micro-banking units to reach micro-entrepreneurs and also other forms of non bank institutions such as pegadaian/rahn/pawnshop, SHG (self-help group), Credit Union (CU), and *Koperasi Simpan Pinjam*/*KSP* (savings and credit cooperative) which have operated in surrounding resident areas.

Particularly for Muslim's clients , in recent, government responded well their needs for Islamic MFI with established BRIShariah in a few years ago in few limited locations in Indonesia. BRIShariah has been a new competitor for BPR, BPRS and BMT. Fatwa prohibition riba have not made any significant impact to the clients' behavior yet. It might come as the religious practices increase in Muslim daily basis.

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