

Issues and Challenges in Financing the Poor: Lessons Learned from Islamic Microfinance Institutions

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Abstract: Despite the potentially important role of Islamic microfinance in making Islamic finance an inclusive financial system, the industry is faced with a wide ranging of issues. By analysing the experiences of two major Islamic microfinance institutions (IMFIs), namely Baitul Maal Wa Tamwil (BMT) in Indonesia and Amanah Ikhtiar Malaysia (AIM) in Malaysia, this study aims to learn from their experiences of the issues facing them in financing the poor. The study offers an area of novelty by undertaking a comparative analysis between both institutions in efforts to understand the peculiarities facing each IMFI, unlike the earlier studies which are commonly focusing on a specific IMFI. By employing a thorough review of the available literature, the study finds that human resource and sustainability are the main issues facing both IMFIs. While human resource is the most important factor ensuring success of the microfinance institutions, structural issues such as reliance on subsidies could jeopardise their sustainability. Findings of this study contribute towards providing important inputs for sustainability of the IMFIs as well as enriching the literature in the area of Islamic microfinance institutions.

1 INTRODUCTION

Generally, microfinance aims at improving the socio-economic condition of the poor through various economic empowerment programs by providing them access to finance at affordable costs. While having a similar objective, Islamic microfinance aims to fulfil the financial needs of the poor and serves as a mean of poverty alleviation to achieve equitable distribution of wealth and income with full adherence to Islamic values. Islamic microfinance has the potentials to play a crucial role in making Islamic finance an inclusive financial system by serving the financial needs of all segments of the society, including the poor who are commonly categorised as “unbankables”. In the South-east Asian region, Islamic microfinance has grown rapidly particularly in Indonesia and Malaysia, where the Muslim-majority populations have created a great demand for shari’ah-compliant microfinance products specially catering for the socio-cultural and religious peculiarities of the poor in these countries. The Islamic microfinance institutions (henceforth, IMFIs) continue to expand their services to provide a variety of financial

services to the poor segment of the community, particularly in the form of micro-financing, micro-savings and micro-takaful. Efforts are continuously taken to integrate the Islamic third sector, namely zakat, waqf and sadaqah into the Islamic microfinance to gradually mobilise the potential fundings from the Islamic social finance.

The global movement of microfinance which started in the 1980s have resulted in different operating models in various parts of the world. In Malaysia, Amanah Ikhtiar Malaysia (AIM) is the largest microfinance institution established in 1987 is considered as one of the most successful IMFIs in the world. AIM continues to receive accolades and global recognitions such as the “Best Microfinance Institution Award” from Global Islamic Finance Awards for four consecutive years from 2013 to 2016. This institution has been mandated to alleviate poverty and increase the household income under the national development agenda, i.e., the Malaysian Economic Transformation Plan.

Meanwhile in Indonesia, Baitul Maal Wa Tamwil (BMT) is one of the successful IMFIs that has grown significantly in numbers for the past twenty years and improved the lives of thousands of

poor people in Indonesia. While being heterogeneous in nature of operations with different locality would have different determinants, the success of BMT are dependent on determinants such as capability of financial management, characteristics of financing customers, capability of risk management, familiarity among customers and managerial team of BMT, adoption of information technology (IT) and network (Hosen & Sa'roni, 2012). Wulandari & Kassim (2016) stated that BMT is able to maintain its sustainability through the fund received from the social religious collection and deposit from saving facilities offered by the institutions. However, sometimes, BMT runs out of their deposit fund due to financing. Hamzah et al. (2013) found that internal factors such as lack of capital and innovation in marketing banking products, shortage of sources of funding, BMT employees underperformance, facilities and technologies that are not up to date affect operational efficiency of BMTs. The external issues are stiff competition among the BMTs, low level of public trust towards BMT performance, lack of networking and cooperation among other financial institutions, lack of supervision and guidance from government and Majelis Ulama Indonesia.

Asmy, Mohammed, & Abdullah (2016) suggested that, to achieve sustainability which is also an issue, cash waqaf system is an ideal option. The cash from donor is channeled to cash waqaf institution before being distributed to microentrepreneurs involved in a *musyarakah mutanaqisah* partnership. A slightly different model of cash waqaf for BMT was suggested by Ascarya & Sukmana (2017). They are suggesting that the cash waqaf is managed by BMT so that BMT can also generate income from it, and therefore can run more socially beneficial programmes. The latter model is better because it makes the microfinance institution to be more independent and have more ownership over their operations. Abdul Wahab et al. (2011) mentioned in their article that fungibility issue, number of employed members and number of sources of income and household's main economic activities are associated with repayment problems in the AIM. Being subsidized by the government, the AIM offers limited microfinance products and has standardized lending contracts compared to Grameen Bank and Bank Perkreditan Rakyat Indonesia (Mokhtar et al., 2012). More diversified products enable customers to choose based on their needs and extend the deliverability of the objectives of the microfinance institutions.

Despite the various success stories, these institutions face different internal and external issues in their operations. While AIM is established as a non-governmental organisation (NGO) receiving grant from the government, BMT is established as a cooperative and being more independent in terms of sources of funds. Being a private trust body mandated to reduce poverty, AIM has a clearer governance structure and thus, has a more stable source of funds compared to BMT. Consequently, a number of BMTs have been shut-down due to financial problems. However, if these two microfinance institutions are scrutinised, there are issues that are unique as well as common to both. This study aims to compare the issues faced by AIM and BMT and highlight how the issues can be tackled by complementing the best practices of each IMFI. In comparing the two IMFIs, extra emphasis is given to aspects that could possibly jeopardize the smooth running of the operations. The AIM and BMT are chosen because these two institutions are the leading example of the IMFIs in the world and therefore, the issues that are faced are of important interest to be shared with avid researchers in this field so that, improvements in the future can be materialized.

2 DISCUSSION

Issues and Challenges Facing the IMFI

Despite the various achievements of AIM and BMT in empowering the poor, there are issues and challenges that they are facing in providing financial access to the poor. These issues and challenges can be categorized into operational, product, and governance aspects. Identification of these challenges are important in efforts to institute suitable measures and undertaken strategies to address the challenges for future development of the IMFIs.

Human Capital Performance

A major issue facing the IMFIs is human capital performance which comes in several dimensions. First, there is a lack of motivations and commitments by the IMFI staff in developing Islamic microfinance products and services. Low understanding in economic principles and Islamic financial transactions aggravate the problem of lack of capability of the human capital. In addition, there are insufficient human resources with good managerial skills to manage the performance of the

institutions. Shari'ah compliance is a key feature of doing business in Islamic microfinance but in practice, many officers and employees of BMT have low financial literacy. This situation is upsetting because it will give impact on the perception of the community towards the image of BMT. The members of BMT are dependent on the institution to educate and support them in understanding and distinguishing between BMT and its conventional counterpart. When these issues on human resources are not addressed accordingly, there are public perceptions that financial products and services offered by BMT are similar with other conventional financial institutions. In reality, most of the administrators and management of BMT have no background in finance and economics.

According to a research conducted by Universitas Islam Indonesia, majority of the BMT administrators are lacked of knowledge and experience about managing Islamic finance institution, thus in practice, the BMT often deviate from the Islamic principles and are inefficient in business management. In general, the BMT started as a small business unit initiated by the public. Having a limited business scope with limited human resources capacity, human resource capability management skill in BMT has difficulty to grow. Due to budget constraint, human development training cannot be undertaken resulting in poor performance of human resources in BMT. This issue causes many BMTs to suffer bankruptcy problem because of operational failure (Nurasyiah et al., 2016). For example, in the case of BMT in Pekan Baru, the study supports that lack of quality human resource and absence of specific regulations affected its performance. The study also states most of the employees in BMT do not have competency as shari'ah practitioners and do not have the understanding about the concept of business (Hamzah et al., 2013).

Little or none has been written on AIM in terms of human resource performance based on the review carried out. This is a research gap that can be focused by future researchers.

Cost of Fund and Perception of Interest

Cost of fund in BMT is higher than the cost of fund in Islamic and conventional banks. This is because BMT has to put in more effort to invite customers to save and deposit their fund in BMT by giving higher profit rate to depositor. At the same time, to offset that cost, BMT transfers the cost to other products which makes other products to cost more. This situation influences perception of the people that

BMT is conducting financing scheme based on riba although BMT claim that they operate their product and service based on shari'ah principle (Kholis, 2012).

It is understood that the basic of Islamic finance is the avoidance of riba. However, the perception of Indonesian muslims on banking interest is still divided even though Majelis Ulama Indonesia has produced fatwa No. 1 in the year 2004 to forbid interest rate. It is important to note that the perception of Indonesian Muslims on interest is classified into three groups: a) interest is riba, thus it is haram, b) interest is halal as long as there is no Islamic bank, and c) interest is halal. This position restricts the opportunity of Islamic finance institution to make ordinary Muslims as their target market because of the different perception on interest (Kholis, 2012).

In the case of AIM, there is zero cost of fund because financing is offered based on qard. However, a 10% service fee called *ujrah* is charged to the members. Saad (2012) argued that this rate is unusually high due to the unique operation of AIM and suggested it to be waived or kept to minimum to honour the spirit of qard hassan and offered to the hard-core poor only. Offering loan in the form of qard by charging service fee resembles conventional loan to the eye of the public. Therefore, AIM as an IMFI should consider introducing Islamic microfinance products based on equity-based financing such as *mudharabah* and *musharakah* to the poor customers. By introducing Islamic microfinance products, AIM will not only become credit provider but more importantly, a business partner to its clients to foster their businesses and provide guidance to the clients to elevate themselves from the chains of poverty.

Legal or Structural Problem and Standardization on Establishment and Operations

To date, there is no specific act and regulation on BMT in Indonesia. The existence of BMT in Indonesia is based on Act of Cooperation and Ministerial Decree about KJKS (Koperasi Jasa Keuangan Syariah /Cooperation for Shari'ah Finance Services). This means that BMT is still governed by the conventional system. The Act of Cooperation only regulates cooperation in conventional structure. In Indonesia, Islamic banks are regulated by a specific act (Act. No. 21 Year 2008). There is no formal standardized regulation for BMT. This problem affects the stability of BMT presence because it gives opportunity for many "blind passengers" to manipulate the noble aims of

BMT for their own interest such as accumulating wealth, getting higher benefit and misusing depositor fund for their own business. The conduct of the business of BMT become unethical and opposite to shari'ah and practical principle. Since there is no act and regulation or standardization for BMT's establishment and operation, fraud cases cannot be taken into court of law and punished. The consequence of their activity is that the reputation of BMT in the society is damaged and compromised (Kholis, 2012).

There is also lack of legal support from government to BMT. Some of the issues are BMT in Indonesia is not governed by legal provisions and there is no suitable supervision system and guidance system. This legal support issues become important considering the fact that BMT is the organization that administers and manages society's funds. Banks have deposit insurance agencies in the event of liquidation but BMT does not have this kind of support. The absence of a clear legal framework may also lead to the inaccessibility of deposit insurance agency. Thus, public savings collected by BMT is not properly protected (Rusydziana & Devi, 2013a).

AIM, on the other hand, is a private trust body that was established on 17 September 1987 and has been registered under Trust Act 1952 amendment 1981 (Act 258). The establishment of AIM is a continuance effort of "Ikhtiar Project" which was a research project led by Professor David S. Gibbons and Professor Sukor Kassim (AIM, 2017). As a registered private trust body, AIM is being governed by Lembaga Amanah Ikhtiar Malaysia mainly by the Board of trustee in which the membership consists of economy planning unit and implementation coordinator unit from Prime Minister department, Ministry of Finance Malaysia, Ministry of Rural and Regional Development, state representative and some other members that were appointed on individual capacity (Cyber, 2017).

The member of the Board of Trustee has the responsibility to ensure the administration, operation, distribution of fund and the implementation of project initiated for sahabat of AIM conducted with due diligence without any misappropriation (AIM, 2017). The operation of AIM is based on the mandate given by the government. In 2013, this institution was entrusted with RM300 million to benefit over 500,000 borrowers by 2015 (Isfire, 2014).

Standardization of Shari'ah Supervisory Board

On the topic of the shari'ah compliance monitoring, Dewan Shari'ah Nasional Majelis Ulama Indonesia

(DSN MUI) has appointed Shari'ah Supervisory Board (SSB) in each Islamic Financial Institutions (IFIs) representing DSN MUI to supervise and ensure that the IFIs operate according to Islamic principles. However, the presence of SSB in every IFIs does not make people feel reassured because people still see the gap between theory and practice. BMT carried out standardization on three major aspects which are the standard operating procedures, human resources and financial statements. The role of shari'ah SSB is still is optimal. Even though SSB is an independent institution whose main function is to supervise compliance of shari'ah in the operations, IFIs need to be aware when they overlook compliance on Islamic principles themselves to avoid the risk of reputational damage. Research on BMT Yogyakarta found that BMT in general has implemented internal control, but there are still weaknesses in the authorization procedures. From 19 samples, only 11 BMT has SSB (Mediawati & Agustami, 2016).

AIM has its own Shari'ah Advisory Board (Panel Penasihat Syari'ah) that carry out standardized supervision. This ensures homogeneity across the products and services offered. No sources are found to criticize or claim the functions of the advisory board of AIM so far.

High Operating Cost and Reliance of Subsidy

The Islamic microfinance providers face the issue of high operating costs in order to maintain financial sustainability. BMT relies on subsidy since the cost of financing incurred is the same regardless of the size of the loans provided to the poor. Besides, high margin reflects the problems of high transaction cost in loan processing. In addition, the issue of high cost will reduce financial inclusion. BMT, on average, distributes around US\$80-US\$400 in loan which is considered small. The administration cost that must be covered by BMT is around 50 percent from the nominal funding. This effectively means that, if there is no support in terms of subsidy for BMT, they must charge high margin to borrowers. Therefore, the subsidy role is very important for BMT to ensure its sustainability.

Subsidy has a direct influence on microfinance. Subsidized lending will have a positive impact on reducing financing rate or margin especially in BMT. Many BMTs search for private donors because the administration is easier than public subsidies. The problem that occurs in BMTs is that many BMTs can only sustain in the first two years without subsidy. After that, many of them collapse. External subsidy is crucial especially for the small-

sized BMTs. Maintaining BMT performance by maintaining subsidy stability is a challenge for BMT. The government, national private companies and international donors have to keep providing subsidized financing sources for the poor using BMT and the importance of subsidy is unquestionable in (Kassim & Wulandari, 2015). Customers prefer Islamic bank financing because of the steadier and more stable flow of fund compared to BMT. Increasing asset and drastic liability mismatch lead liquidity risk and the less resilient BMT is prone to external shocks (Ascarya & Sukmana, 2017).

Delegated with the task of alleviating poverty in Malaysia, AIM receives strong financial and non-financial support from the Malaysian government and its agencies, which is critical to its sustainability. Financial support comes in the form of interest-free government financing, grants and soft loans through allocations made under various Malaysia Plans. Similar to conventional microfinance institutions, AIM unavoidably experience high transaction costs due to asymmetric information problems. These costs relate to monitoring and searching costs and the cost of administration, which are all directly associated with the information problems in the rural financial markets. Small loans are expensive because of high overhead costs, which usually have a large fixed cost attached. AIM must find a mechanism to reduce transaction costs as added costs are often passed onto clients.

AIM still depends heavily on the support from the government and related agencies for funding. The operational cost of AIM is relatively high and salaries and administrative cost from the major proportion of operation cost, nevertheless creating only a small portion of assets. By means of a fixed administrative charge of 10%, it does not cover its operating costs and could not be sustainable and self-dependent. AIM should look again on their fundamental principles because of the loss of direction in focusing on the not so poor or non-poor and giving larger loans and better-off borrowers. Therefore, there is no incentive from such institutions to offer any other microfinance products apart from microcredit loans to finance their operation. This theory also occurred in BMT which many of them searching for private donor because the administration is easier than public subsidies as mentioned earlier (Abdul Rahman & Dean, 2013). If costs are not covered, the capital will be depleted and continued access to financial services will be difficult. Therefore, AIM should seek financial

funding from variety sources other than government to maintain their sustainability in the long-term.

Repayment Problem among Members

Geographical distance is important because it will lead to Islamic microfinance efficiency. The higher distance will cause more credit rationing problem. One of the features for the people at the bottom of the economic pyramid is that, they live in the remote areas which are far away from financial institutions including BMT. People who live near to BMTs have lower incidence of credit rationing. One of the difficulties facing the poor borrowers in accessing credit is the distance between the people and the BMTs. In practice, BMTs need to include the distance between the BMTs and the borrower to help in deciding whether they should get financing or not. This is because short distance will make the monitoring process easier and the application would have a greater chance of being approved. The distance of a borrower's house from BMT is also a determinant of credit rationing. Financial services nearness is described as poor people who live nearer to microfinance institutions and can be contacted. People who live closer to BMT will have easier access to financing since it will reduce the cost of monitoring because it does not require BMT staff to take public transportation that would acquire a cost. A greater risk will be faced by BMT if they give funding to far away borrowers (Wulandari & Kassim, 2016).

Furthermore, the long travel time from home to BMT cause customers to get less access to information and updates. It also makes the frequency of customers' meetings with BMT employees getting smaller so the chances of bad repayment rate increase and smaller participation of the customer of BMT to borrowing. For example, in BMT Khairu Ummah located on Jalan Raya Leuwiliang, Leuwiliang, Kabupaten Bogor, as well as two branches of BMT Khairu Ummah located in the Cigudeg and Puraseda Village, Leuwiliang have a bad repayment rate and one of the reason are the customers' home are far away from the BMT agency (Effendi & Utami, 2016).

AIM members also have repayment issues, but the cause of the issue is different and related to client selection procedure of AIM that starts with measuring potential clients' average monthly household income. Households with average monthly household income below the Poverty Line Income (PLI) has been calculated by the Malaysian government since the year 1976. It was estimated based on the necessity of food and other basic needs

and would be considered as absolute poor, while households with average monthly household income below half of the PLI would be categorized as hardcore poor. Therefore, households whose average monthly household income falls below the PLI, including both poor and hardcore poor households, are considered to be eligible to obtain microcredit from AIM.

Microcredit services offered by AIM are not free from repayment problem. Based on the survey in Kelantan, Terengganu and Kedah, more than 50% of the total respondents reported that they used credit in non-income generating activities, which increases the chance of encountering repayment problem. Repayment problems can lead clients to leave the program or become inactive borrowers. When hardcore poor households' income streams are interrupted, which is commonly the case, the clients may have to sell their fixed assets to repay the loan. AIM therefore has to consider a flexible loan policy to allow poor and hardcore poor households to reorganize the loan when clients encounter any financial crisis. AIM should also focus on appropriate training and development programs in order to enable the hardcore poor households' to use credit in income generating activities, grasp employment generating opportunities as well as find and invest in new income generating activities, which eventually reduce their repayment problem (Abdul Wahab et al., 2011).

Lack of Business Knowledge and Technical Skills

BMT is faced with the lack of entrepreneurial development in the community (Rusydia & Devi, 2013b). When potential members do not have the skill to run a business, upward social mobility cannot be achieved in the event of the members fail. The lack of exposure and education also contribute to the non-delivery of the financing granted with the intention to assist the poor to increase their income. PBMT Institute is one initiative to provide training program related to managerial aspect of BMT in order to produce competent and high-quality staff and deal with human resources problem. However, not many BMTs are interested to send their staff for the programme since it requires some payment of fee (PBMT, 2015).

In the Malaysian environment, entrepreneurship culture is not well-blend amongst the Malays and Bumiputera as compared to the Chinese. For Chinese, most of their businesses succeed and they transfer down their skills through generations. Hence, knowledge in business management and related technical skills have to be given to all

microfinance borrowers, when majority of them are Malays and Bumiputera. In recent development, AIM provides business and financial management course to their borrowers. However, according to the borrowers, only selected borrowers will be chosen to attend the course. AIM also does not have a standardized module of training specially to handle different level of borrowers. For example, the level of understanding financial and business management topics may vary from each borrower. Moreover, the trainer or the speaker also needs to make simpler for the information and knowledge given because the audiences lack education.

Based on the research, many AIM borrowers lack knowledge on how to manage their business income. Most of them do not know how to separate their business income, between their business and personal consumption. Many borrowers allocate a large portion of their income for personal consumption and only a least amount for their businesses. Many use their businesses to financially support their daily living expenses and make little effort to expand their businesses. This is one of many reasons, why some of their businesses unsuccessful even after continuous microcredit loans. The major constraints for the poor have always been the dependence on a single economic activity and the lack of skills to vary their sources of income to supplement their daily living (Mason, Wan Azmi, & Madden, 2015). The success of microfinance depends largely on the skills and understanding of the people managing the microfinance programme given the unbankable nature of microfinance clients themselves, namely low literacy level, having little knowledge about business, and having no physical assets.

3 CONCLUSION

Despite the various success stories of AIM and BMT, both IMFIs have their own shortfalls. They have almost similar categories of issues, being formed having objective of poverty alleviation, most issues stem from criteria of the members as well as the staff of the institutions. Members with no background in business and IMF staff with no shari'ah training and exposure are among the most serious potential factors for failure. Therefore, human capital, from the members and the IMFs, play pivotal role in ensuring the success of the social financing.

Another glaring issue is the reliance on subsidies of AIM and dependency on donors by BMT.

Inevitably, the nature of profit maximization is not the modus operandi, hence, these IMFs need to find other source of funding such as SRI sukuk that has been gaining ground over the recent years. This can be further looked into in future research.

AIM is blessed with the support from the government, while the BMT lacks this legal support. Some amendment to the laws pertaining IMFs would accommodate their growth. Shari'ah issue is not seen as a stumbling block for the operations of AIM but for BMT, it is more serious. The role of shari'ah supervisory board is still minimal and the mixed perception of the Indonesian public on riba puts restriction for BMT to widen its market.

In summary, internal issues can be managed by the IMFs and government but external issues that concerns the mindset of the members need intervention from more parties. BMTs issues are more complex to be solved because of the non-standardization elements in the operations as compared to AIM. A special task force looking into each and every BMT for improvement is ideal but difficult.

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