

# The Challenges of Bad Debt Monitoring Practices in Islamic Micro Banking

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**Abstract**—The study aims to assess and compare the monitoring procedures in two Bank Syariah Mandiri (BSM) branches located in Cengkareng and Duri Kosambi of West Jakarta city. The research implemented qualitative data analysis tools that consisted in to develop Focus group discussion (FDG) to obtain reliable and depth data related to monitoring practices among loan officers. Meanwhile, interviews were designed to the branch managers of each institution to determine their role in the NPF management. The study results divide into two parts: On the one hand, it highlights the standard monitoring procedures for the Non-performing financing (NPF) in Islamic micro banking and the main differences between conventional and Islamic in NPF management. On the other hand, the second result exposes three main key findings: First one, it confirms the importance of count on proper risk management for Islamic micro banking and harnessing of the sharia principles to maintain the quality of the portfolio. Second, the study reveals a correlation that exists among screening, monitoring, and enforcement, thus how a proper testing and supervision practices may affect in the following steps of the loan cycle. Finally the third one, it shows the impact of real leadership from the head manager in the performance of the institution.

**Keywords**—Islamic Micro banking, Monitoring, Non-performing financing, portfolio quality

JEL classification: G02, G14, G21

## I. INTRODUCTION

In the last thirty years, Islamic bank has been developing, and it started in Egypt 1970 as an initiative in the rural area. Since that time Islamic bank it has been spread around the world especially for those countries with dominant Muslim population (Iqbal & Molyneux, 2016). Furthermore, challenges of development and growth of Islamic banking differs according to the country thus each country has its own such as historical, social and economic condition. According to Sukmadilaga & Nugroho, (2017) and <sup>a</sup>Nugroho et al.,

(2017), the argumentation of Islamic bank established in several countries as follows:

- In the Middle Eastern countries, the increase of petrodollars commercial activities in 1970-1980 was the most significant driver for Islamic finance development. For Middle Eastern countries such as Saudi Arabia, Kuwait, and Bahrain Islamic banks represent around 48.9%, 44.6% and 27.7% of the market share;
- In European countries due to the increasing phenomena of Islamic banking, many Middle East investors move their funds from conventional banking to Islamic banking in their country. Therefore, European governments especially the United Kingdom started to develop policies that boost and enable conventional banks to establish either Sharia financial services in parallel with conventional financial services or only pure Islamic banking institutions. Financial institutions that offer both conventional and Islamic financial services are named Islamic windows. Furthermore, fully sharia-compliant institutions were established at that time;
- In Malaysia, the Islamic banking development was driven by the government policies that allow the rapidly growing and the desire to become a hub for international Islamic funds. Therefore, the government develops policies related to the tax breaks and license facilities that look attractive to investors in the Islamic Finance industry in Malaysia. The major establishment of Islamic banking was the Bank Islam Malaysia Berhad (BIMB) in 1984;
- In Indonesia, the Islamic Banking has been developed relatively late mainly because of the Pancasila (five pillars) as the fundamental way of life in Indonesia that recognizes the free will of people to hold a religion. The recognize religion in Indonesia are Christian, Budha, Hindu, Catholic, Konghucu, and Islam thus the economic activities were developed separately from religion. However, the majority of the population of Indonesia is Muslim around 85% (Venardos, 2012 and bureau statistic of Indonesia).

So, the religious context and the Muslim scholar development were the main catalysts that encouraged the growth of Islamic Banking activities. The Muamalat Bank is the first Islamic Bank in Indonesia, it was established in 1992.

The principle of Islamic Finance based on equality, social justice, no discrimination and the protection of the weak people (Venardos, 2012; Arafah & Nugroho, 2016). Such concepts align with the Microfinance ideals which pursue secure access to financial instruments for people with low income exposed to the "triple whammy" (Mersland & Strøm, 2012; Collins et al., 2009). However, inside Islamic Banking there is Microfinance product (Nugroho, 2014). According to Armendáriz & Morduch (2010) and Sheth et al. (2011) microfinance has to contemplate both finance and social approaches to keep financial sustainability and expand the outreach of its operations. Concerning to financial aspect, sustainability is correlated to manage the risks such as credit risk, operational risk, reputation risk, liquidity risk. Therefore, since the major part of the asset of MFIs is compound by the outstanding loan, MFIs have to focus on the quality of its portfolio and must develop effective screening, monitoring and enforcement practices (Chakrabarty & Bass, 2015; Shu-Teng et al., 2015). Microfinance industry has particular characteristics which differ from the conventional banking sector such as high volume, high risk and high administrative cost (Mersland & Strøm, 2012).

Islamic Banking is developing around worldwide especially for Muslims countries as a new pathway to offer microfinance services that align with sharia principles. Furthermore, within the Islamic Bank industry of Indonesia, Bank Syariah Mandiri (BSM) has the major in term of their assets, branches (extensive network) and market share on Islamic Banking. BSM has microfinance products designed to fulfill the microentrepreneurs and low-income sector which follow the BSM vision and mission (annual report of BSM, 2015).

The rapid growth of Islamic Banking might imply a worsening of the quality of microfinance services that means a relaxing on the screening or monitoring process (Assefa et al., 2013). Hence an increase of non-performing loan (NPL) that since now is going to be called as non-performing financing (NPF) which is the terminology used in Bank Syariah Mandiri for the NPF. Thus, increasing of NPF become critical for Islamic microfinance services providers to work consistently on the improvement of screening, monitoring, and enforce collection (figure 1)

Figure 1. NPF/L of Islamic Bank VS NPF/L of Conventional Bank



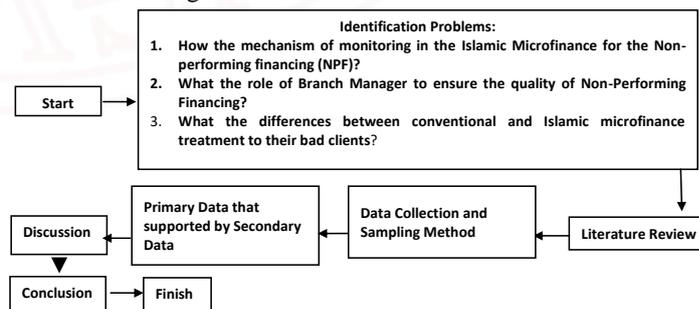
Source: <sup>b</sup>Nugroho et al., (2017)

The nature of Microfinance services has a focus on clients who are exposed to the “triple whammy” means low, irregular and unpredictable income (Collins et al., 2009). Moreover, most of those clients do not count with fixed assets which in conventional financial institutions are used as collateral. So, for MFIs work with this segment of customers implies high risk. Therefore to anticipate the high of NPF, monitoring practices have a significant role in the quality of the portfolio, as a part of the risk management actions. Monitoring embeds in the credit cycle and to anticipate the default by detecting early sign of bad debt (Churchill & Coster, 2001).

II. METHODOLOGY

Regarding Hulme (2000) that stresses the advantages of qualitative research to get depth information that quantitative methods cannot achieve. Therefore, the study was conducted in the qualitative method that located in two BSM branches were developed focus group discussion (FGD) among the micro banking team (loan officers, micro-manager, administrative, risk analyst). To collect information related to the monitoring mechanism for the clients in arrears, and the main differences between conventional and Islamic practices. Furthermore, it was also conducted interviews with the branch managers to collect information about the role that they play in the NPF (same as NPL) performance. Also, BSM provided data such as annual report, micro strategies, and organizational structure of micro banking, that supported the research. The research mechanism is going to implementing as in figure 2. flowchart below:

Figure 2. Research Mechanism Flowchart



Source: Own

The data was collected from two branches that historically have different performance regarding NPF thus through a comparison analysis also it was possible to find both good and bad practices. The final insights were used to develop recommended strategies that might enhance the current operations in both branches. The structure of the questionnaires strives to fulfill the research questions set as objectives: Description of the monitoring mechanism in Islamic banking, find the main difference between conventional and Islamic banking, and the role of the branch manager in the NPF management. Furthermore, the hypothesis of Scardovi, (2015) was evaluated. This theory sustains that features such as a segment of the client, the training degree of the staff, and macroeconomic characteristics have an impact on the NPF's behavior. Therefore, as an ex-ante hypothesis, the study considers that NPF performance relies on both internal and external factors (Scardovi, 2015).

#### A. Forum Group Discussion (FGD)

The questionnaire 1 (one) was used as a guide to conduct the FGD between the Micro banking team (loan officers, micro banking area manager, administrative, risk analyst) and the researcher. The questionnaire considered two parts; the first one pursued to understand the internal performance inside the micro banking area, and the second one was oriented to describe the monitoring mechanism. The questionnaire as follows:

Questionnaire 1: The Guidance Questions for FDG with The Loan Officer for exploring information related to Micro Banking Internal Practices and the procedures for clients with arrears as follows:

1. What is the composition of the client portfolio (%employees and %entrepreneurs)?
2. a. How often do you receive training or workshops to improve the quality of the services delivery? (Formal)
- b. How often do you organize sharing session within the staff to improve the quality of the services delivery? (Informal-cafe morning, etc.)
3. How do you screen the client before the loan disbursement? Therefore, what features do you analyze in the character, capacity, collateral, capital, and conditions?
4. Why do you think that 5c's assessment is essential for loan approval?
5. Do you think that the 5c's elements have to be embedded in the credit evaluation process?
6. Do you have a formal manual procedure to manage the non-performing financing (NPF)?
7. What are the procedures for the clients with arrears as follows?.

Collectibility 1	Collectibility 2	Collectibility 3	Collectibility 4	Collectibility 5
Describe the handling of arrears account?	Financing at Risk (FAR) (30 days-90 days)	Financing at Risk (FAR) (120 days-180 days)	Financing at Risk (FAR) (180 days-270 days)	Financing at Risk (FAR) (>270 days)

8. In your experience what are the major causes of default among the clients (internal and external)?

9. What do you think that are the main differences between conventional and Islamic banking during the collection practices?

#### B. Interviews

The questionnaire 2 (two) was used as a guide to interviewing the Branch managers and the researcher to determine the role of the branch manager has in the NPF management and the staff performance. Moreover, the interviews were used to reveal the micro strategies and also to describe the segment of clients that each BSM micro banking branch focuses, the questionnaires that relate are below:

Questionnaire 2: Questionnaire for The Branch Manager

1. What are the strategies that you apply to enhance the performance in the micro banking area?
2. How often do you organize training activities for the staff of micro banking area? What are the topics?
3. What is the limit for NPF? What is the warning value?
4. What are the characteristic of target clients for the micro banking area?
5. How strong is the communication between the branch and headquarter?

#### C. Secondary Data Information

BSM facilitated the access to documents that were helpful to support the results from the qualitative methods. The annual report was used to describe BSM as all Islamic Bank and its commitment to pursue sustainable development in Indonesia. The micro business strategies were used to explain the segment orientation of the micro banking area, describe the standard procedures for credit processing, risk management, and their training strategies for the staff.

#### D. Forum Group Discussion (FGD) Observation

The principal aim of observation is to understand the screening, monitoring and enforcement activities inside the branches through empirical observation. Therefore, during the internship two weeks were exclusively dedicated to understanding the operational mechanism in Cengkareng and Duri Kosambi branches Units (West Jakarta, Indonesia).

### III. LITERATURE REVIEW

Islam is a holistic religion. Therefore, all the affairs of the world and the hereafter have been described in Islam (Doktoralina & Bahari, 2017). As in Al-An'am 38, it means: "And there is no creature on [or within] the earth or bird that flies with its wings except [that they are] communities like you. We have not neglected in the Register a thing. Then unto

their Lord, they will be gathered.” The commercial activity is the nature of human beings because with a human endeavor to fulfill various needs. Any business run by people will inevitably lead to two consequences in the future, namely profit and loss. Thus the risk itself is a nature that is always inherent in human life. Therefore Islam does not recognize the existence of risk-free business transactions. The logical consequence is the person entitled to profit is the person who must bear the loss (if it happens). A trader is allowed to take advantage of the goods he sells because he has assumed all the risks associated with his merchandise (damage of property before a sale, loss of merchandise, unsold and so on). Based on these rules then Islam prohibits any transactions in which there is an imbalance between risk and profit. In other words, Islam prohibits any profit-making deal without any willingness to bear a loss. That is why Islam forbids any additional (interest) in debt transactions that can occur in the conventional financial system. The lender has no risk whatsoever for the funds it lends because Islam requires each borrower to pay off his debt. Therefore, any additional debt repayments are considered usury.

The principle of risk management in Islamic perspective is “al Ghorm bil Ghurmy al Kharaj bid Dhamany” (Soekapdjo et al., 2018) that means “any gains are risks, and these risks must be managed responsibly.” Islamic banks in lending/financing will inevitably face the risk of financing problems. Nevertheless, according to Soekapdjo et al. (2018), the low level of risk management in an institution will fail the establishment. Moreover, it can even lead to a loss of confidence from investors. The internal and external environments of the banking sector have grown rapidly, resulting in increasingly complex business risks. Therefore, to keep pace with the rapid development of bank business, it is necessary to implement adequate risk management. Sufficient risk management policy can support the bank's business growth optimally while maintaining the principle of prudence.

The primary structure of risk management includes identification, quantification, and monitoring of the risks. Therefore, the analysis of critical indicators and risk trends is necessary to prevent and control the risk among financial institutions (Van Greuning & Iqbal, 2008). Indeed, there are several risk drivers such as include credit risk, operational risks, market risk, liquidity risk and systematic risk (Churchill and Coster, 2001; Rahman et al., 2014). However, for Islamic bank face additional risk such as non-compliance risk. Nevertheless, regarding Hull (2012) credit/financing risk is the highest risk that is facing by the conventional bank and Islamic bank. Islamic law also teaches the “la darara wa la dirara” rule in which we are not allowed to engage ourselves in harm that will harm or destroy ourselves without any attempt to minimize the harm. Even in Al-Baqarah verse 195, its mean: “And spend in the way of Allah and do not throw [yourselves] with your [own] hands into destruction [by refraining]. And do good; indeed, Allah loves the doers of good.” This rule encourages Islamic banks to be more careful in managing their business activities so that any inherent risks to the bank's business can be minimized and managed

properly. Before approving the financing proposal, the sharia bank must know the profile of the prospective customer, especially related to the inherent risk to the customer. By knowing the risk of each customer, the sharia bank can develop risk mitigation measures to minimize the potential loss from the existing risk. The bank should take prudentially provide loan for the client. This has happened to the banking industry in Indonesia 1997-1998. The banking crisis that occurred during that period was triggered by the behavior of many banks in Indonesia which easily lend to unworthy debtors without taking into account the level of risk and risk mitigation measures that can be done to minimize potential losses that may occur. The booming loan disbursement resulted in high bank bad debts in 1997-1998, causing public confidence in banking institutions to decline dramatically, especially the bank that majority portfolio loan in the corporate segment.

Islamic bank objectives is not only to achieve financial performance but also to achieve social performance that objective create social well-being (masalah/beneficiaries for ummah/community) therefore, Islamic bank has focused on microfinance services (Akhtar, 1998; Dhumale and Shapcanin, 1999; Al Harran, 1999; Ahmed, 2002; El-Gamal, 2006; Wajdi Dusuki, 2008; Arafah & Nugroho, 2016; Aysan et al., 2016). Furthermore, according to Prastowo (2015), Islamic principle in the financial institution such as Islamic Bank should concern in sustainability that means the business activity should be a concern not only for presents condition but also taking considerations for next generation. In Islamic point of view, all the business activity included Islamic bank the objectives are not only a triple bottom line (Profit, People, and Planet) but extended into Prophet, Profit, People and Planet which mean the bussiness activities should comply with the sharia principle (Chotib & Utami, 2014; Nugroho et al., 2018).

On the other hand, financing to the micro-entrepreneur sector is constrained by several things. Microentrepreneurs do not have a standard financial report format, even if there are often unaudited. So the financial information provided is less reliable (unreliable). The condition is theoretically known as information opacity. In addition to information opacity, other factors that make Microentrepreneurs less desirable by banking is; The micro business is new, there is no guarantee/adequate collateral, little technological mastery and the founder and manager of microentrepreneurs do not have sufficient managerial experience managing the business (track record) (Schurmann and Johnston, 2009; Ibtissem and Bouri, 2013). The existence of information opacity, causing banks are reluctant to channel funds to Microentrepreneurs. If willing, the bank will ask for higher yields as the potential increase in the number of nonperforming loans as a result of mistakes to choose the debtor (adverse selection). To minimize this risk, the bank should use an effective selection tool to distinguish which debtors will default or fail after the bank approves its financing request.

Information Opacity of Microentrepreneurs is not only a problem for banks at the time of selection but also occurs

during the period of financing running (Kiweu, 2011). The value of financing given to Micro entrepreneurs are small, but the number is very much. This condition is called granularity and causes enormous monitoring costs for banks. In the end, this can reduce the efficiency of the bank's operations. Therefore, banks serving the SME sector are required to have effective and efficient supervision.

Nevertheless, sharia banks (including BSM) remain committed to developing the real sector. This can be demonstrated by the portion of financing for Microentrepreneurs that are consistent at the level of 60% of the financing portfolio provided. It is no secret that the SME sector is an area with a very high yield, higher than the corporate sector. *Al ghumu bil ghurmi*, high-risk, high return, that is *sunnatullah*. If you want to get a high yield, then be prepared to bear a high risk as well. Therefore, the Islamic bank risk management system needs to be ready to minimize adverse selection risk and to reduce the necessary monitoring costs.

#### IV. RESULTS AND DISCUSSION.

##### A. BSM micro banking scenario

As it was described above the analysis was conducted in two BSM sharia branches. Historically, Cengkareng branch during 2014 had faced an unstable financial situation where the NPF surpassed the safe range with an NPF higher than 10 %. Therefore, Cengkareng had to freeze the credit unit, which entailed that the credit officers had to stop looking for clients and focused only on the collection of installments of defaulting customers. Currently, Cengkareng branch has recovered from the bad situation and still walking toward continuous improvement, until now it has a 0,9 % of NPF which still in the green zone. Moreover, Duri Kosambi has a different landscape because historically it had managed to keep an acceptable NPF of 0%, and currently still maintains control of the NPF because Duri Kosambi has active screening strategies that prevent adverse selection.

##### B. Finding in the FGD with the loan officers

The analysis of responses of the FGD in both Cengkareng and Duri Kosambi branches highlights the findings described below:

###### 1) Client's profile

In Cengkareng, previously during the bad situation, the portfolio was mainly compound by entrepreneurs than employees, approximately 60%, and 40 % respectively. However, currently this figure had changed, so at this time the portfolio is 60% clients with a fixed source of income such employment, the double source of income, or lease business, while the rest 40% are clients with their own business.

In Duri Kosambi the figure is opposite; the current portfolio is mainly composed of entrepreneurs approximately 70%, employees 20% and the remaining 10% are hybrid clients, means customers with more than one source of income such as employment and own business.

###### 2) Training for the staff

For the staff training, both branches have the same understanding of the difference between formal and informal training.

In Cengkareng the informal training considers a group in social media (WhatsApp) that connects all the micro team to share information regarding clients, solve together some difficulties, etc. Furthermore, the team has meetings during the breaks exchange information between each other, also the "day of knowledge" (minimum once per month) to solve problems related to the services, share some knowledge, or answer any internal problem.

In Duri Kosambi the figure is similar. Also, they have a group in the social media, but at the end of the day, all the micro team has a meeting to review the agenda's compliance, the difficulties faced along the day and find together the solution.

For the formal training, both institutions receive workshops from the learning area of BSM headquarters, minimum twice per year. The loan officers have to be prepared to develop many functions such as sales, screening, monitoring, and collection.

###### 3) Credit Analysis procedures

To some extent, both institutions have the same scheme of credit analysis thus both assess the 5C's (character, capacity, collateral, capital, and condition).

a) *Character*: The main features that loan officers have to consider during the character assessment are: Data from the credit bureau, credit history of the client, personal documents, how is the relationship with his relatives, neighbors and suppliers, testimony from the local leader, corporal expression during the interview that the client's honesty.

b) *Capacity*: At this step the micro officers collect information from the Credit Bureau (collectability category, current loans, etc.) and to proofs of the source and the amount of income (inflows), Clients expenses (outflows), the value of the customer's ownership (house, vehicle, inventory), payment system with his supplier. Deletion: Delete the author and affiliation lines for the second affiliation.

c) *Collateral*: At this level, the credit agency has to collect information about the assets that the clients present as collateral such us Certificates of ownership, land location, the market value of the property, Check the taxation of the building. Deletion: Delete the author and affiliation lines for the second affiliation.

d) *Capital*: The micro officer has to build the balance sheet using the information provided by the client and evaluates the value of the customer's equity.

e) *Condition*: This stage entails an assessment of economic and market features that might insert risk of default in the applicant.

Both institutions (Cengkareng and Duri Kosambi) are consistent with the fact that is important to assess the 5C's. However, both consider that for Micro banking clients the

character, capacity, and collateral are the most critical features in credit analysis.

4) *NPF management*

Both institutions are governed by the central bank regulation that classifies the client compliance in five categories. However, the actions for each category depending on the different level of client's overdue. Therefore, the pressure strategies will tend to increase in parallel with the time of default. The enforcement tools described in the FGD consider calls, messages, and visits to clients, shock therapies that consist into visiting the clients with all the micro team to put pressure on him, use the religion as an enforcement collection mechanism, use the relatives, family and local leader, warning letters, among others.

Table 1. the client's compliance they are categorized and treated as following

Collectibility 1	-We block the saving account named sinking fund (internal). -We call the client some days in advance to remain him the day of payment. Also, we visit the clients to monitor the performance of his business (external)
Collectibility 2a > 30 days	-We send the first <b>warning letter</b> -We <b>call, send message, and visit</b> the client to collect the installment
Collectibility 2b > 60 days	-We send the second <b>warning letter</b> -We <b>call, send message, and visit</b> the client to collect the installment. -We implement <b>enforcement strategies</b> such as the game of good and bad guy, shock therapy talk with his relatives, promise of second loan.
Collectibility 2c > 90 days	-We send the third <b>warning letter</b> -We call, send message, and visit the client to collect the installment. -We implement more strong <b>enforcement strategies</b> such as the game of good and bad guy, shock therapy talk with his relatives, promise of second loan.
Collectibility 3 > 120-180 days	-We proceed to <b>put stickers and make scenes</b> that make think the client that the bank is going to take his collateral in order to put social pressure.
Collectibility 4 > 180-270 days	-We proceed to <b>put stickers and make scenes</b> that make think the client that the bank is going to take his collateral in order to put social pressure.
Collectibility 5 > 270 days	-We proceed to <b>take the collateral</b> and according to policies we can <b>write-off</b> the loan.

5) *Sources of default*

Regarding the internal source of default, the perception of both institutions is different. In Cengkareng the internal factors are related to the internal operations of the branch while in Duri Kosambi the internal source is related to internal problems in the client's household such family problems, loan sharing, liquidity problems.

Though, regarding the external source of default, both institutions agreed that the main issue is related market and economy.

Table 2. the major causes of default among the clients (internal factor evaluation and external factor evaluation)

Cengkareng

Internal	The performance of the business
External	Market risk

Duri Kosambi

Internal	-Family problems (marriage, children, relatives)
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	-The client asks the loan for another person (fake loans, broker) -Share the loan mainly between family members (broker activity) - Liquidity problems (accounts receivables)
External	-Market risk -Changes in the macro Economy conditions

6) *Differences between conventional and Islamic banking*

Both institutions stress that enforcement procedures are the main difference between conventional and Islamic banking. According to their comments, Islamic banks use the religious values as an enforcement mechanism thus they appeal to the client's conscious. Also, the intensity of enforcement practices among Islamic banks increases progressively while in the conventional sector the enforcement procedures tend to be more severe since the beginning.

Table 3. the main differences between conventional and Islamic banking during the collection practices

Cengkareng

Islamic	Conventional
→Not allowed to be rude in the beginning	→They are rude since the beginning
→Use the sharia principles as an enforcement alternative	→They do not use the religion as an enforcement alternative
→Appeal to the conscious of the client	

Duri Kosambi

Islamic	Conventional
→The client receives the complete amount, but he has to pay the up-front fee before to receive the loans	→The client receives the loan amount minus the up-front fee
→They use the religion as an enforcement strategy	→They do not use the religion as an enforcement strategy
→They are more polite and diplomatic. They use rigid enforcement techniques only in extreme cases	→ They apply rigid collection strategies since the beginning
→Appeal to the Muslim leader	

7) *Screening, monitoring, and enforcement in Cengkareng vs. Duri Kosambi*

From the observation of the daily activities and the comments from FGD, it was possible to recognize that there are specific differences between both branches in the screening, monitoring and enforcement activities

a) *Selection:* In Duri Kosambi the micro officers stress a lot on the selection process to diminish adverse selection

(Karlan & Zinman, 2009). Therefore, they invest much effort to make sure that the client is financially capable of affording the loan. In Cengkareng currently, there is a lack of administrative personnel. Thus, the micro officers have to be capable of developing sales screening, monitoring, enforcement, and administrative activities.

b) Additionally, the micro staff in Cengkareng is quite newer. Thus, they have less time experience comparing to Duri Kosambi. Therefore, the two extreme difficulties mentioned above have an impact on the screening quality of Cengkareng which is still toward continuous improvement of its agency's activities.

c) *Monitoring*: At this level, both described more or less the same monitoring procedures. Therefore, both branches use calls, message and regular visits as a defensive mechanism to anticipate the default of the client. Such mechanisms of warning are named Early Warning System, however on the other hand after the loan disbursement, the micro officers start to follow the evolution of the client to identify some signals of default, also to keep strong relationships with the clients. Through the observation method, it was possible to acknowledge that each BSM's client is visited at least once per month.

d) *Enforcement*: On this stage, both institutions take advantage of the religion as an enforcement tool that seems to have good results, as their portfolio is mostly compound by Muslim clients. According to the opinion of the micro officers, this element makes a big difference between conventional and Islamic banking (Iqbal et al., 2006). Moreover, the institutions describe the enforcement procedures which are soft at the beginning, but these tend to become harder as long late time is increasing.

### C. Findings in the Interviews

#### 1) Micro-banking strategies

BSM settle yearly the micro-strategies that act as the guide to drive the activities of each branch. However, the branch manager has the freedom to organize its staff and activities as long as it fulfills with the broad parameters of BSM headquarters. In this sense, the strategies within branches may vary by the branch manager creativity and the context of each branch. In Cengkareng for instance, the branch manager drives the institution according to what he calls "triangle of leadership" which consists in to develop strategies that boost leadership among all the stakeholders. To this end, the Cengkareng Manager strives to enhance continuously the agents which are the Leader, follower and the environment.

In Duri Kosambi the branch manager has a different strategy that encourages the team working and mutual solidarity among the staff, which means that he puts the effort in to harmonize the work among all the staff.

#### 2) The role in the training of the staff

All the branches count on a formal manual of practices that has to be shared with the newer staff and periodically reminded of the old team. Nonetheless, each branch manager has his

method to spread the manual among the staff likewise the area micro banking manager who is in charge to make sure that the staff of each branch in West Jakarta knows the formal procedures described in the manual.

In Cengkareng, the branch manager created the "Knowledge day" that regularly take place at least once per months and consists of a meeting among the staff to receive some training regarding topics that may be useful to improve the service accompanied by spiritual messages. The objective is to foster BSM values in the branch, positive thinking, and proactivity among staff. Moreover, the branch manager is to any consult from the staff. In Cengkareng, the branch manager is conscious of the lack of personality in the micro banking thus the branch manager strives to boost independence, proactivity, and creativity among the staff to make them able to deal with such lack. Therefore, each micro agent in Cengkareng is capable of developing functions like sales, screening, monitoring, and enforcement.

In Duri Kosambi, the branch manager boosts continuous surveillance of the internal performance inside the branch where the more expertise micro officers shared their knowledge with the newer integrant to prepare him to deal with the most demanding clients or solve any difficulty. Besides, as the internal policy, the micro team has daily a meeting to follow its performance and solve together problems.

Moreover, the Area micro banking manager is the agent in charge of supervising the performance of both branches thus he also delivers training to keep the staff updated about practices that enhance the quality of service likewise the financial sustainability of the area micro.

#### 3) NPF limits

According to policies of headquarters, the performance of the NPF is classified into three zones that shown in figure 3 below:

Figure 3. NPF classification



- Green zone*: when the NPF is between 0 to 1%,
- Yellow zone*: that goes from 1 to 3%,
- Red zone*: when the NPF is higher than 3%.

On this stage, both institutions take advantage of the religion as an enforcement tool that seems to have good results, as their portfolio is mostly compound by Muslim clients. According to the opinion of the micro officers, this element makes a big difference between conventional and Islamic banking (Iqbal et al., 2006). Moreover, the institutions

describe the enforcement procedures which are soft at the beginning, but these tend to be.

Furthermore, if the NPF is above 5% the unit of credit has to be a freeze, means that the micro officers must stop the sales of credit and shift only to collection activities until reach an acceptable NPF. In this sense, the branch managers have to follow the formal procedures and instructions of headquarters. become harder as long late time is increasing.

#### 4) Segmentation

Although branch managers have the freedom to manage their agency activities, also they have to drive their strategies toward the fulfillment of the business strategies of headquarters. There is not an explicit instruction for the type of client (employees, entrepreneurs, hybrid). Thus the branch has the freedom to settle his portfolio composition as long as they consider the client's needs.

#### D. Discussion between findings and literature review

According to the interviews, it seems that Duri Kosambi has better risk management strategies comparing to Cengkareng. Duri Kosambi emphasizes on the screening activities to avoid the client exceeds the collectivity 2b which means no more than two months, according to the comments from Duri Kosambi manager the branch has not faced until now clients that surpass 60 days of overdue. In contrary Cengkareng during 2014 had to come out from financial instability. Until now Cengkareng manager is capable of surfacing the crisis and currently keeps an acceptable NPF despite the staff limitation. Moreover, in Cengkareng the staff is newer than Duri Kosambi thus the staff still has to develop natural skills than come over time.

##### 1) Risk acceptance

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##### 2) Credit Analysis

Regarding credit analysis, both institutions assess the 5 C's (character, capacity, collateral, capital, and condition) of each application. However, both consider the character, capacity and collateral assessment as core features in the microfinance field. The figure between Cengkareng and Duri Kosambi is opposite. However, both have the same appreciation of the clients which are classified into three categories:

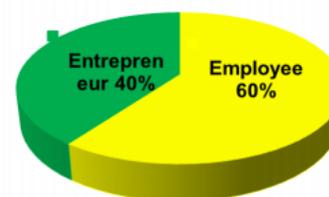
- Entrepreneurs
- Employees
- Hybrid (Those who are both at the same time)

Note: In Figure 4 of Cengkareng branch the percentage of employees includes the percentage of hybrid clients.

#### Cengkareng

Currently, in Cengkareng the portfolio composition has a major percentage of employees which are 60%, and 40 % are entrepreneurs (Figure 4). According to the branch manager, the reason is that the clients with fix source of income tend to be less risky than real entrepreneurs. Therefore, they seek customers who have a second source of income means that even if they have a regular job in parallel, they develop their own business and need some capital to invest. Such as client fulfill the capacity requirements. However, any client is a good candidate as long as he is capable of proving his financial ability to repay.

Figure 4. Micro Financing Portfolio of Cengkareng Branch



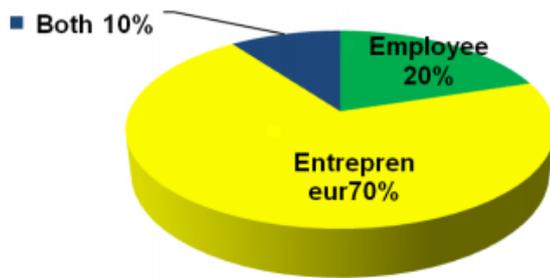
The clients with a second source of income are included in the 60%. The history of Cengkareng highlights that the behavior of the NPF is positively correlated with the entrepreneur's percentage. Therefore, the meanwhile higher percentage of the pure entrepreneur in the portfolio, the NPF in Cengkareng tends to be higher.

#### Duri Kosambi

According to the theory of Mersland and Strom, (2010) which supports that in emerging economies, micro and enterprises might be an attractive market opportunity for microfinance services providers. Duri Kosambi embraces this theory thus the figure is different, they support mostly the entrepreneurs. The entrepreneur sector commonly has an income which is sensitive to external features thus tend to be fluctuating. Therefore, during the screening process in Duri Kosambi, the micro officers are more exhaustive.

Moreover, the micro officers take advantage of their innate work experience that equips them to assess efficiently the entrepreneurs' ability to pay. In Duri Kosambi branch the significant percentage of the portfolio is compounded by clients who are entrepreneurs (Figure 5). According to the comments of the micro officers, the entrepreneurs' customers in Duri Kosambi are dedicated mostly to rent, groceries, and repairs services.

Figure 5. Micro Financing Portfolio of Kosambi Branch



### 3) Training strategies

Even though the topics for the training in both institutions pursue the continuous enhancement of the quality of services, both managers' strategies are supported by different bases. It consists in to boost leadership, independence, skills to cope with problems and creativity. On the other hand, the dimension of climate environment pursues to create enabling an environment that encourages efficiency, solidarity, and satisfaction of the staff.

In Duri Kosambi the central pillar is supported by work team and mutual solidarity among the staff. The branch manager is entirely convinced that under a good work team the micro officers may quickly solve any problem inside the institution. Therefore, in Duri Kosambi there is a daily meeting at the end of the day to review the daily compliance, exchange experience, and work together to solve problems. For the newer staff despite the formal training, the new team is supported by the former officers who have more skills gained in the field.

### 4) Collection

To some extent, both institutions have enforcement techniques. However, in Cengkareng the most effective mechanisms are the promise of a new loan and encourage social pressure from relatives, family or local leader (Gine & Karlan, 2008). Meanwhile, in Duri Kosambi the most effective mechanisms are first the religion and second what is named "shock therapy" which involves all the team visiting the client. The shock therapy is usually used when the clients overdue is higher.

## V. CONCLUSION

Islamic Bank acts as financial intermediaries providing access to financial services such as savings, loans, insurance, remittances. Therefore, Islamic Bank has to be active for screening, monitoring, and enforcement activities. The experience of BSM proves the inherent relation among screening, monitoring and enforcement and the importance of developing innovative monitoring mechanisms that allow anticipating bad debt. Also, it requires awareness from customers that debt obligations in the perspective of Islamic law are mandatory so that in the case of arrears, then it is caused by business failure is not due to bad faith from customers.

In the last years, technology has been developing rapidly to facilitate operations in every kind of field. In field Microfinance sector the information technology (IT) is an innovative tool that can save optimize operations and cost among MFIs. Currently, it has been acknowledged that tools such as management information system MIS decrease significantly the burden of MFIs operations. BSM micro banking has basic MIS that allows them to manage the information of clients and monitor the indicators each certain period

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