# IMPROVING FINANCIAL EDUCATION TO THE POOR AT THE BOTTOM-OF PYRAMID: THE ROLE OF SOCIAL FINANCE VIS A VIS FINANCIAL INSTITUTIONS

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**Abstract**

This paper aims to explore the role of Islamic social finance and financial institutions in contributing towards improving financial inclusion through financial education among the poor. While there have been a lot of efforts undertaken by financial institutions, especially microfinance institutions, to achieve the financial inclusion agenda, the financial inclusion programs would normally require high operational costs which many financial institutions would consider them as not commercially viable. The costs then are transferred back to the customers, resulting in the financing/credit cost higher than commercial financial institutions. As a result, incidences of bankruptcyincrease when the cost of credit is higher. Thus, financial education is essential for average family in managing their day to day financial resources. While financial institutions keep busy with financial inclusion agenda and trying to find the best way without disturbing their core business agenda, Islam offers social finance institution (*amil* and *nadzir*) as the solution to this problem.

**Keywords**: Islamic social finance institutions, Islamic financial institutions, financial education, financial behaviour

## INTRODUCTION

In efforts to protect consumers and the society in general, the Indonesian Financial Services Authority (or Otoritas Jasa Keuangan –OJK) through the OJK ACT No. 21 Year 2011, stated that consumer and society should be given information and education regarding financial services characteristics, its products, and facilities. This role highlights the OJK's position as a regulator and organizer of financial system in Indonesia, while at the same time protects the right of the society, especially customers and users of the products and services of the financial institutions.

The population in the bottom of pyramid, especially the low-income micro-entrepreneurs, are having a very limited access to working capital financing/credit. This is attributed to various reasons including lack of experience, low education level, and low credit balance, resulting in substantial constraints for them in getting the access to credit. These reasons also applied for the subsequent credit balances situation (Zhu & Meeks, 1994). The various forms of credit constraints to the poor are challenges to the financial inclusion effort, which promotes the idea that accessto credit isthe right of human being, where the low-income households may acquire credit through microfinance institutions. The supporting system of this concept has tremendously developed. However, as the access to credit for this population arose, the over-indebtedness risk as the potential economic dangers has been repeatedly highlighted. Amid these issues, the idea of financial inclusion is very much doubted(Hudon, 2009).

Accessibility to credit by the Muslims is subject to several considerations. Mohammed (2011) stated that Muslims should be discouraged to incur debt and encouraged to do saving due to the fact that while savings refrain current consumption for better future consumption, debt brings future's consumption to current, thus leaving the heir in a worsen situation. Also, from the economic perspective, current consumption based on financial optimism of better and higher future income can be quite risky as the financial improvements might not be realized due to various possibilities such as economic and financial shocks, or even future uncertainties such as sickness and death.

These detail aspects of financial accessibility are highly relevant in the context of Indonesia where large proportion of the poor people at the bottom of the economic pyramid are Muslims. This situation should be disclosed and repeatedly informed to the targeted population, i.e. poor and low-income individuals and households through carefully designed financial education program. An intense program, such as continuous technical support system, mentoring, counselling, monitoring and forming a group to assist the system, is highly needed in order to establish a productive, successful and fruitful poverty alleviation agenda through financial assistant programs.

Various efforts have been undertaken by the financial institutions, especially the microfinance institutions (MFIs) in order to achieve the financial inclusion agenda. However, the financial inclusion programs would normally require high operational costs which many financial institutions would consider them as not commercially viable. The costs then are transferred back to the customers, which in turnresult in the financing/credit cost offered by the MFIs to be higher than that offered by the commercial financial institutions. As a result of the increased cost of accessing credit, the poor are refrained from taking up credit, or they end up defaulting in repayments. An increase in credit use has led to an increase in personal bankruptcies even in rich countries such as the United States (US), Austria, Korea, and Germany ((OECD), 2006). For example, in the case of the US for, one out of ten US households reported to face bankruptciesin 2003. Financial education is essential, particularlytothe low income family in enabling them to manage their day-to-day financial resources and avoiding them to land into financial difficulties.

This paper aims to explore the role of Islamic social finance and financial institutions in contributing towards improving financial inclusion through financial education among the poor. It aims to provide a structured and integrated program proposalto alleviate poverty in Indonesia through social finance institutions which is compared with financial institutions.

## LITERATURE REVIEW

Improved financial education can be a highly effective method to improve financial literacy among the society. As stated in the Noble Qur'an (55:33) human should gain knowledge. Financial literacy is basically the possession of basic knowledge about how to earn or make financial resources, manage it for the readiness in various unexpected future events, and disburse it to help others (Mccormick, 2009; Giesler & Veresiu, 2014). It is also important to know how to properly utilise it according to the budget constraints. Financial education is one piece of puzzle to achieve a well-literacy in finance among the consumers. Hogarth(2006) mentioned that disclosures and information, substantive protections, and professional advice are some pieces to complete the puzzle. This is because, being well-literate in finance is including for being knowledgeable, educated and informed regarding managing money and assets, which is comprising in planning, implementing, and evaluating the financial decisions (Mccormick, 2009).

Through improved financial literacy, one is hoped to be better-able in using the resources, increasing economic security, improvingcontribution in the community, and finally building a thriving community and well-educated labour force (Hogarth, 2006). This is simply because there is a correlation between knowledge and behaviour wherethose who are equipped with better financial education and knowledge are more likely to undertake recommended financial behaviour(Hilgert & Hogarth, 2003).

Therefore, priority audiences of financial education need to be properly identified and targeted. Youth is targeted group to be prepared (Mccormick, 2009) where financial education would enable youngsters to observe financial discipline early in their lives. However, there are studies which found that high-school students who took personal financial management course were no more literate than those who did not take it (see, for example, Mandell & Klein, 2009). Another targeted group is the low-income households. Financial education is proven to improve financial knowledge (Zhan, Anderson, & Scott, 2006; Muflihani, 2015;Martin, 2007),improve skills (Muflihani, 2015), and change financial behaviour effectively (Lyons, Chang, & Scherpf, 2006)particularly amongthe low-income populations in many countries.

In summary, in efforts to attain better outcomes in the form of changing behaviour towards better financial discipline, especially in creditworthiness, the following steps are suggested:

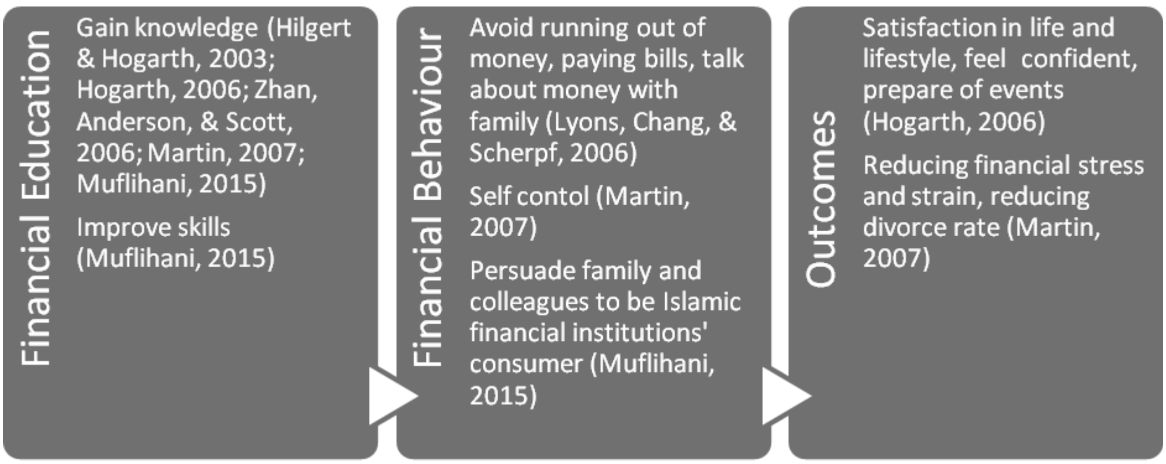


**Fig 1**. Outcome of financial education

The above figure demonstrates that at the end of financial education process, the low-income population is hoped to perform a good financial behaviours and eventually reflected in the mentioned outcomes.

## FINANCIAL EDUCATION THROUGH FINANCIAL INSTITUTION

Consumers in Indonesia are able to access financial services from wide-range of financial services providers through various types of financial institutions available in Indonesia such as banks, insurance companies, finance companies, investment companies, pawn broking, leasing companies, securities companies, and many MFIs (including *baitul maal wa tamwil* (BMTs), cooperative, and up to the loan shark for informal institution). These institutions are involved in collecting fund from the society and invest it in the form of other financial assets, for example, credit, securities, checking account, and other productive assets; Bank and non-bank financial institutions are included in financial institution (OJK, 2015). Meanwhile, the non-bank financial institutions are collecting funds directly or indirectly from the society by issuing securities and sell them to finance the company's investment, either as a credit/loan or as an additional capital.

Since many financial institutions are providing financial servicesto the society, individuals as well as households are facing a situation that forces them to decide wisely for their financial affairs. In order to make good decision, consumers should have sufficient knowledge that can drive them into utilising the knowledge to efficiently utilize products and facilities offered by the financial institutions. Due to the importance of adequate financial education, the Organisation for Economic Co-operation and Development (OECD) has pointed out the importance to improve financial literacy through financial education (OECD, 2006).

Three out of nine points of recommendation on principles and good practices for financial education and awareness have mentioned the role of financial institutions. Those are included good governance, human resources, and clients to support financial education program.Meanwhile, financial institutions, at the very beginning of their commencement aim to earn as much profit as possible. Even the MFIs charge higher rate of return than commercial financial institutions (Yumna & Clarke, 2009). They argue that the high operational cost is needed to be covered. Furthermore, while the society, particularly Muslim population, has been offered a glance solution from Islamic financial institutions, it seems fail to attract this part of population. In fact, they charge higher than conventional counterpart as the operational and overhead costs are high relatively compared with the portion of their market share (Beik & Arsyianti, 2008). Thus, the idea of Islamic financial institutions to overcome poverty problem in Indonesia may seem impossible at a glance. Cost is still a question to reach financial education effectiveness (Willis, 2011).

A clear and direct interaction as the services provided by financial institutions is through customer service desk. However, mass media is still being the effective way to educate their customer(Muflihani, 2015; Hogarth, 2006).Customer service desk may be the effective way to educate customers in person. However, its efficiency is questioned since customers should wait for their turn in not a short time.

Another way is through seminar and public talk. As many people can be gathered in one place, one time. Financial institutions can be collaborated with OJK and/or universities to organize the seminar or talk. As explicitly stated in OJK Act, OJK must have programs correlated with financial education. By having these programs, OJK must have its own budget set by government since OJK is government institution. The condition, thus, can be benefited by financial institutions to spread the knowledge about deposit, credit, securities, checking account, and other productive assets to the society. University has ample and credible human resources than can help the programs to be realized. Student's organization is still the active human resource in organizing this kind of event.

However, these programs are specifically made for those who have easy accessibility to formal financial institutions. Therefore, financial education programs, in this regard, which help to manage daily basis spending as well as preparing to finance future life are particularly matched for the wealthy and average family or individuals. What about the poor and low-income households who have limited access to formal financial institutions? The following section will discuss about it.

## FINDINGS AND DISCUSSION

In Islamic financial system, there are several social finance institutions that could play the function of educating the consumers at the bottom of the pyramid, apart from their normal functions of collecting and distributing charity, endowment or other free money. Specifically, *Waqf* Act No.41 Year 2004 and Zakat Management Act No.23 Year 2011 (replacing Act No.38 Year 1999) provide the solutions to this issue. *Waqf* and zakat institutions have played the main role in social finance. Both directly deal with the donors as well as the ultimate recipients. Majority of the recipients or the ultimate users, highly utilize the funds in Indonesia are categorized as poor and low-income households (Yayasan Dompet Dhuafa Republika, 2013; Badan Amil Zakat Nasional, 2015), which perfectly match the financial inclusion resolution. Unlike financial institutions, social finance institutions are rather keen to disburse the collected funds without aiming for any profit motive.

According to the Zakat Management Act, as an *amil*, National Board of Zakat (Badan Amil Zakat National – BAZNAS) and Private Zakat Institutions (Lembaga Amil Zakat – LAZ) are able to collect zakat as well as other social funds. Zakat is a compulsory mandate, while waqf results in stable and permanent expected benefit(Obaidullah, 2008). Both are *sadaqa* in Islam, while another type, *infaq*, is voluntary basis and may be discharged according to the mandate (Yumna & Clarke, 2009). Thus, *infaq* can be used for any kind of purposes and not limited to the *mustahik* group.

Islamic social finance institutions have more options to finance their program compared with other financial institutions. First of all, they are the one who directly and regularly keep in touch with the poor and low-income households and individuals. This situation makes them to easily understand the situations facing the poor, thus able to effectively educate the poor and low-income households and individuals. As reported in annual report of social finance institutions in Indonesia, the poor is still the main targeted group to disburse the collected funds.

Secondly, in line with government's effort to alleviate poverty in Indonesia, relevant authoritative bodies can collaborate with OJK, Social Ministry, as well as Ministry of Religious Affairs. As stated in Zakat Management Act, operational of BAZNAS can be financed from state budget (Anggaran Pendapatan dan Belanja Negara – APBN) as well as from its right of *amil* fund.The similar situation also prevails in Indonesia Board of *Waqf* (Badan Wakaf Indonesia – BWI), which is stated in *Waqf* Act that government should support BWI financially. OJK can provide the material and human resources. Meanwhile, along with Social Ministry and Ministry and Religious Affairs, social finance institutions may integrate their programs. Thus, there will be no overlapping events.

Thirdly, social finance institutions are also in line with society's desire to provide a better financial life. Zakat Management Act has put society contributions in explicit term. It is verse 35 that stated where society can contribute. However, the Act mentions zakat only in particular. Social finance institutions in Indonesia can encourage muzakki or munfiq or waqif to actively share their knowledge, build the recipients' skill to utilize financial facilities, and build their trust to control their financial problem.

Moreover, the free money the social finance institutions get can be distributed without a burden to get more and more profit. The performance of these institutions is not assessed by its profit rather they are assessed by their activities in collecting and distributing the funds and effectively give impact to the society.

## CASE STUDY

One of success inspiring stories which was done by BAZNAS of Meranti Regency. Meranti Regency in Riau Province of Indonesia is one who has succeeded transform 136 poor households whom categorized as *mustahik* or zakat recipients has become *muzakki* (zakat payers and must be a Muslim) in a model that combined debt, savings, and charity organized by the institution of the Regency Board of Zakat of Meranti (BAZNAS Meranti). Zakat is a charity-giving obliged for Muslim whose wealth has been exceeded specific amount called *nishab*. Present perfect sentence here is used because the wealth also needs to be held within specific haul, i.e. one year. The indicator of wealth *nishab* can be approached through one's monthly income. As stated in Hafidhuddin (2002, p. 97), it is called "zakat of profession". *Nishab* "zakat of profession" in Indonesia derived from an equal amount of 653 kilograms of paddy or wheat, which are collected every month when Muslims received their income. There is no haul in "zakat of profession" since it is derived from zakat of agricultural, where Muslim farmers whose production output exceeded nishab are obliged to pay zakat right away during the harvest time (Qur'ān, 6:141). The nature is the same with employee or entrepreneur or any other profession who usually calculate their income in monthly periodic. Collected zakat funds, then, must be distributed to *mustaḥik*, the recipients of zakat funds.Mustahik comprises eight groups of people as stated in the Qur'ān, 9:60. They are the poor, the needy, the officials (appointed) over them, those whose heart are made to incline (to truth) or muallaf, the ransoming of captives, those in debts, those in the way of Allah and the wayfarer.Charity in this term is different from zakat. This charity can be done by any Muslims without any requirement of nishab and haul like zakat.

BAZNAS Meranti program was actually to distribute zakat funds to the veracious recipients (mustahik). Amil institution gave the mustahik an initial amount of 2 million rupiahs (less than 200 US dollar). The transaction contract was hibah (charity) in condition that the mustahik should deposit back the funds in order to get the full ownership. Depositing method they used was instalment payment through savings. Until their account eventually reached 2 million rupiahs, the ownership of the fund was fully in them. Along with savings, the mustahik were encouraged to participate in workshops and to give charity (infak) in order to motivate them escalating their level up to muzakki. In this situation, the *mustahiks*' mind set were fortified that the funds were in their responsibility, even though the status was *hibah* (charity), they were required to deposit back the fund to educate them in managing their finance.

Meanwhile, Dompet Dhuafa (DD), which appears as the biggest player of social finance institution, believes that education is important since the poor has not reached his/her adult stage. Therefore, DD focus on empowering the poor as early as possible. Besides health, economy and social development, DD establishes various educative and scholarship programs for poor children. DD has carved many achievements and many graduates which were proven to be as excellent as those from other superior schools. The programs are not just made for beginners and students but also for the teachers. DD also provides programs for building technical, entrepreneurship, and marketing skill for the poor. The aim for their program is to make an excellent human resource, thus they can be independent financially.

## CONCLUSION AND RECOMMENDATIONS

Both social and financial institutions are responsible to educate society. Contemporary financial institutions match with the higher income population, while social finance institutions suit for establishing this bottom-of-pyramid population. The remedies are deeply considered in the extent of cost, time consuming, and possible collaboration with other institutions. Financial literacy is not only about gaining knowledge through financial education but also performing better financial behaviours. Eventually, this process will produce the expected outcomes. Although financial institutions take major role in financial system, through financial education, the whole population can take place to build a better national economy and finance.Thus, it is not impossible to say that small action of low income population can achieve bigger vision of nation.

In this regard, if government wants to win low-income consumers in financial inclusion agenda, more needs to be learnt in to what extent their financial education needs. For example, what their current financial knowledge and financial behaviour position is. What steps should be taken to deliver and attract the low-income consumers to be succeeded in their financial life. Sharing information on good programs and experiences at international and national level to promote financial services accessibility and financial management can be helpful. More works are needed to develop these programs. Investing time and money to achieve the programs is required. Thus, social finance institutions role is very much needed to support government agenda in financial inclusion through financial education for low-income populations.

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