

# The Role and Impact of Islamic Microfinance on the Development of MSME in Rural Indonesia

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## ABSTRACT

This study investigates the role and impact of Islamic microfinance on the development of micro, small, and medium enterprises (MSME) in Garut, Indonesia. Utilizing a mixed-methods approach, the research combines a survey of 50 MSME beneficiaries with in-depth interviews involving Islamic microfinance institutions (BMTs, BPRS) and BAZNAS Garut officers. The findings reveal that 64% of MSMEs experienced increased business revenue, 48% expanded assets, and 36% created new employment opportunities after receiving Islamic financing. Most respondents reported high satisfaction with Sharia-compliant contracts, citing religious alignment, transparency, and ethical values as core advantages. Qualitative insights show that Islamic microfinance institutions foster strong trust among clients due to their community-based and faith-driven operations. However, the study also identifies challenges, including low financial literacy, misperceptions of Sharia contracts, limited post-financing support, and institutional constraints. Government Zakat Institution in Garut provides role in distributing productive zakat has shown promising results in supporting women-led groups and ultra-micro entrepreneurs, though sustainability mechanisms remain underdeveloped. This research contributes to the literature on financial inclusion and Islamic economic empowerment, offering practical recommendations to enhance the effectiveness and long-term impact of Islamic microfinance in rural areas.

**Keywords:** Islamic microfinance, MSME, Garut, financial inclusion, economic empowerment

## INTRODUCTION

Micro, small, and medium enterprises (MSMEs) have become an important part of the economic development of national and regional Indonesia. Another example is that MSME (Ministry of Cooperatives and SMEs Republic of Indonesia 2023) dominates more than 99 percent of the entire business units in Indonesia and employs more than 97 percent of work forces throughout the country. In Garut regency, the small and medium enterprises (MSMEs) in rural and a semi-urban city in Indonesia have a significant contribution towards local development, and the ability to reduce poverty, to increase employment, and to empower the rural society was generated by MSMEs (Bappeda Garut, 2022). Despite their relevance to economic growth, MSMEs are experiencing severe barriers to access formal financial services, either due to no collateral or credit history, no

availability of bankable documentations that made MSMEs were not eligible for regular financing from conventional bank (Bank Indonesia, 2021). This underscores the value of alternative, inclusive financial options such as Islamic microfinance that are consistent with the beliefs and needs of largely Muslim populations. Islamic microfinance fuses conventional microfinance practice of providing financial service delivery to un-served, underserved, and unequally served world's poor people or communities with the application of Sharia rules and principles of financial services such as *mudharabah* (profit-sharing), *murabahah* (cost-plus financing), *ijarah* (leasing) and *qardhul hasan* (benevolent loans). Unlike the normal practice in microfinance, Islamic microfinance relies neither on interest (*riba*) nor on equity and profit/revenue participation and instead, ethical investment, risk sharing, and social justice represent the common method of transactions (Obaidullah and Khan, 2008; Dusuki, 2008). These values are in accordance with the religious beliefs and values of Muslim entrepreneurs, thus Islamic microfinance not only provides a financial solution but is also consistent with the environment and culture provided by institutions such as *Baitul Maal wat Tamwil* (BMTs), Sharia Rural Banks (BPRS), and zakat-based empowerment programs run by BAZNAS (Ascarya, 2011; KNEKS, 2022). Notwithstanding their importance, a lot of MSMEs continue to face challenges, especially in terms of limited access to formal financial services. Traditional financial institutions generally perceive that it is risky to lend to MSME because of their lack of collateral, limited financial information, and informal nature of business (Beck et al., 2005). Islamic microfinance has developed as a potential alternative financial model in such a condition, especially for the Muslim community, as Garut. Several pieces of research have demonstrated that Islamic microfinance generates a significant amount of empowerment to low-income people and small businessmen. For instance, Ahmed (2002) pointed to the role of the Islamic microfinance in poverty alleviation without losing its religious morality. Likewise, Hosen and Muhari (2021) and Abduh and Ameen (2011) Islamic microfinance has high prospects to develop, including the potential areas in Garut Regency, West Java. The Financial Services Authority (OJK, 2023) noted that many Sharia Rural Banks (BPRS) and *Baitul Mal wat Tamwil* (BMTs) have been trying to finance MSMEs in trading, agriculture, beverage, and handicrafts. Concurrently, workouts of productive zakat become the concern of the local agent of the National Zakat Agency (BAZNAS Garut) through empowerment efforts for MSMEs and women in the pro-poor communities (BAZNAS Garut, 2023). Nevertheless, there is scarce evidence that examines how real the effect of Islamic microfinance on the development and sustainability of MSMEs in Garut. Absent this localized evidence, it remains challenging to assess the extent to which financial services foster entrepreneurial ability and socioeconomic progress. This paper is conducted in order to investigate the influence of Islamic microfinance against MSME development in the case of Garut. Namely, to answer the following research questions:

1. What are the forms of Islamic microfinance products used by MSME in Garut?
2. How does Islamic microfinance contribute to the financial and non-financial performance of MSME?
3. What are the challenges of a relationship between Islamic MFIs and MSME? By addressing these questions, this study endeavours to add to a body of literature examining Islamic finance and MSMEs and offer policy advice on ways to enhance the effectiveness of Islamic microfinance at the grassroots level.

## LITERATURE REVIEW

### Islamic Microfinance: Definitions and Basic Principles

The mission of Islamic microfinance (also called microfinance Islamic banking or Mujtama's banking) is to integrate both poverty alleviation and social welfare with the overall development of Islamic economics and Islamic finance. In contrast to traditional microfinance, based almost solely on the provision of interest-bearing loans, Islamic microfinance avoids *riba* (interest), *gharar* (uncertainty), and gambling-related activities. It encourages risk-sharing, financing through the backing of assets and social equity, under Shariah contracts including profit – and – loss sharing (*mudharabah*), partnership (*musharakah*), cost-plus financing (*murabahah*), leasing (*ijarah*), and benevolent loans (*qardhul hasan*) (Obaidullah & Khan, 2008). Objectives of Islamic microfinance are not purely economic, but moral and social as well. It is premised on *maqashid al-shariah* or objectives of Islamic law, which cover the protection of wealth, life, religion, mind, progeny (Dusuki & Bouheraoua, 2011). In this manner, Islamic microfinance is not solely perceived as the provision of money and credit but as a means to uphold fairness, human decency, and economic fairness (Ahmed, 2002).

## The Role of Islamic Microfinance in the Development of MSMEs

In recent years, microfinance has been well regarded as one of the tools to help MSMEs, particularly in the developing world (Armendáriz & Morduch, 2010). Islamic microfinance institutions (IMFIs) may have a comparable function by providing access to capital for Muslim micro-entrepreneurs who have been marginalized from traditional banks either because of religious reasons or lack of collateral. Some researchers have proved the significance of Islamic microfinance as it relates to business performance and improving livelihood. For example, Abduh and Ameen (2017) observed that Islamic microfinance significantly enhanced income and business sustainability of women microentrepreneurs of Indonesia. Likewise, Hosen and Muhari (2021) revealed that Islamic microfinance improves productivity and the expansion of business for MSMEs, especially if accompanied by mentoring and capacity building programs. In a wider context, Islamic microfinance has also been associated with social empowerment, i.e. increased decision-making powers, assurance, and independence, especially among women-owned enterprises (Karim et al., 2008). Furthermore, MFIs are able to nurture closer relationships with their customers in the case of local, proximity-based operations and religious ties, which will increase trust and reliability (Obaidullah, 2015).

### Islamic Microfinance in Indonesia and Garut, Java

With the sixth-largest Muslim population in the world, Indonesia is fertile ground for the development of Islamic microfinance. Islamic microfinance institutions such as *Baitul Maal wat Tamwil* (BMTs) and Sharia Rural Banks (BPRS) have been increasingly encouraged by authorities and civil society organizations and are found in Indonesia's urban and rural areas (Ascarya 2011). As of 2023, there are more than 160 BPRS operating in Indonesia, with more than one established in West Java, such as in Garut, which offers Islamic loans to MSMEs in agriculture, trade, or manufacturing. Islamic MFIs play a role in the Garut area. Several Islamic MFIs have actively provided Islamic microfinance products to the local MSME's needs. Nevertheless, few research has been conducted on the effectiveness, extension, and future socio-economic contribution of these institutions only in the Garut area especially. This is an important research hole.

### Research Gap and Theoretical Lens

Although it has been reported in various international and national studies that Islamic microfinance has the potential to develop MSME as well as reduce poverty, however, there is no empirical research in context in Garut and in general sub-urban areas showing how Islamic microfinance affects MSME. This paper seeks to address this gap by drawing on local knowledge and qualitative understanding to evaluate the impact on both financial (e.g., business revenue, asset accumulation) and social (e.g., empowerment, religious fulfilment) outcomes. Two overarching theories guide the research:

1. The Theory of Financial Inclusion: that readily available, low-cost financial services are necessary for individuals and businesses to participate in economic development (Demirgüç-Kunt et al., 2018).
2. *Maqashid al-Shariah* Framework: used to judge the ethical and developmental objectives of financial service activities beyond the pursuit of profit (Dusuki & Bouheraoua, 2011).

## METHODOLOGY

### Research Design

As a mixed-method study, this research will facilitate the comprehensive examination of the effects of Islamic microfinance on the MSMEs in Garut. On the other hand, the qualitative: on perceptions, experiences, and challenges, of both the microentrepreneurs and the Islamic microfinance institutions (IMFIs). Its design enables a more in-depth analysis of both quantitative results and social, religious, and institutional processes.

### Research Location

This research was undertaken in Garut Regency, West Java, while taking the Islamic MSMEs that become the beneficiaries of Islamic financial service products of BPRS, BMTs, and BAZNAS Garut as the object of study.

Some certain municipalities, such as Leles, Tarogong, Bayongbong, and Cisurupan, were experiencing intensive Islamic microfinance activity, where formal as well as community-based Sharia institutions participate and operate.

### Population and Sampling

The samples consist of a questionnaire for MSME actors who have been funded by the Islamic microfinance institutions or zakat-based MSME empowerment programs for a period of > 6 (six) months and in-depth interviews with the leaders of IMFIs and economic empowerment divisions of BAZNAS which provide facilities on an ongoing basis or have just ended the division of funding to micro-entrepreneurs.

The sample size consists of:

1. Survey sample (50 MSME respondents).
2. 8 key informants (from BMTs, BPRS, and BAZNAS) for in-depth interview.

### Data Collection Techniques

Survey Questionnaire: Distributed to MSME to assess:

Type of Islamic financial contracts applied (*murabahah; mudharabah; qardhul hasan*)

1. Adjustment of company income, asset value, customer pool, and employee pool following funding
2. SHARIA compliancy and affordability, as perceived by consumer levels.

In-depth Interviews: Held discussion with BMT/BPRS managers and BAZNAS Garut officials to determine:

1. Operational issues in the provision of Islamic microfinance
2. Product development and sharia governance arrangements
3. Incorporation of productive zakat and financing mechanism

### Documentation Review.

Compiled from internal reports, brochures, and local government websites on MSME development and zakat distribution in Garut.

### Data Analysis

1. Descriptive and correlation analysis on the relationship between financing access and business performance are applied to the quantitative data collected from the survey.
2. Qualitative data is analysed using thematic analysis, with patterns in perceptions, challenges, and institutional practices being coded and interpreted to inform or complement quantitative results.

### Validity and Reliability

1. For the survey instrument, a pilot test (pre-survey) was conducted with 5 MSME to ensure clarity and reliability.
2. To enhance the validity of findings, triangulation is used by relying on survey, interview, and document data.
3. Ethical issues such as consent for participation and confidentiality were thoroughly adhered to.

## RESULTS AND DISCUSSION

### Overview of Respondents

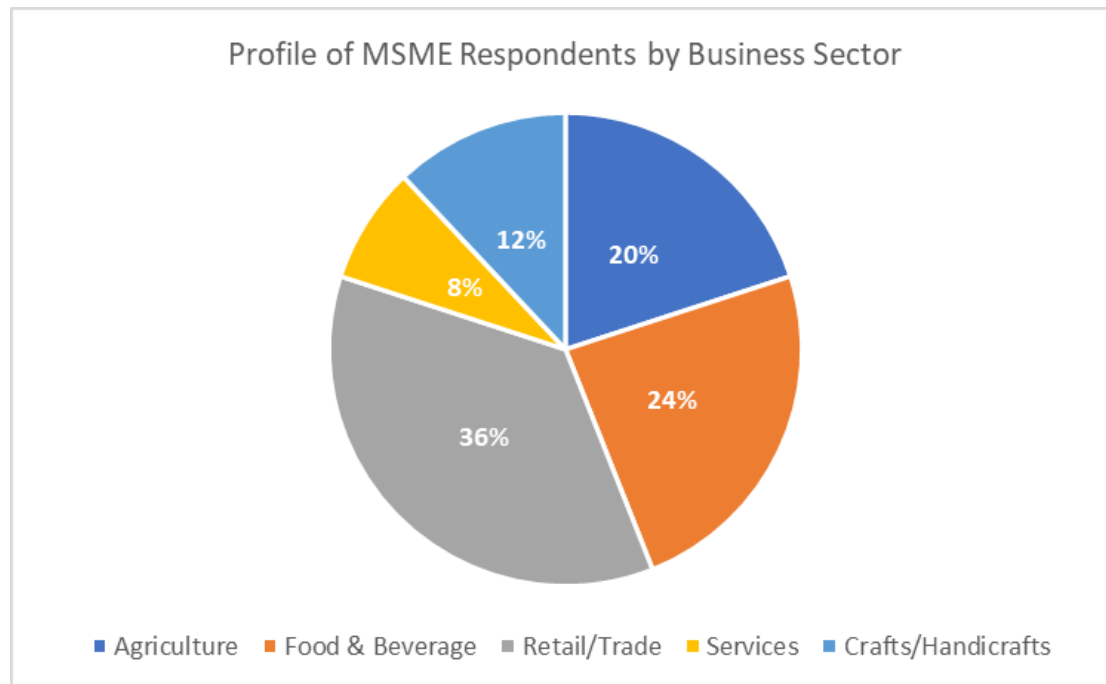


Figure1. Respondents profile

A total of 50 MSME respondents from various sectors—culinary, agriculture, small-scale trade, and handicrafts—participated in the survey. Most respondents (70%) had received financing through *murabahah* contracts, 20% through *qardhul hasan*, and 10% through *mudharabah*. The majority of them operate in rural and semi-urban areas such as Leles, Bayongbong, and Tarogong Kaler.

From the qualitative side, interviews were conducted with 8 representatives: 3 from BMT institutions, 2 from BPRS, and 3 from BAZNAS Garut's economic empowerment division.

### Impact of Islamic Microfinance on Business Growth

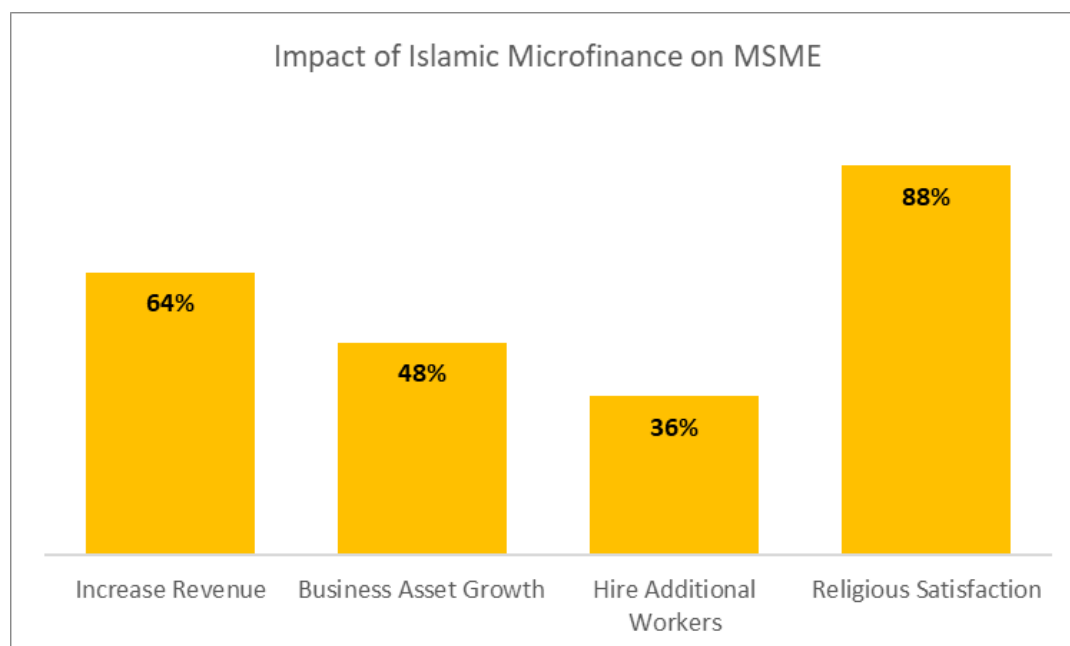


Figure 2. Impact of Islamic Microfinance on MSME



Quantitative analysis showed that:

1. 64% of respondents reported an increase in monthly revenue (average increase: 20–35%) after receiving financing.
2. 48% were able to expand their business assets, such as buying new equipment or increasing inventory.
3. 36% hired at least one additional worker, showing job creation potential.
4. 88% of respondents stated that the financing model used is aligned with their religious beliefs, and 74% preferred continuing to use Islamic financial products in the future.
5. From the interviews:
6. Respondents emphasized that transparency in contract terms, flexibility in instalments, and absence of interest were among the main reasons for their preference for Islamic microfinance.
7. However, many MSME still lacked basic financial literacy, making it difficult to manage capital effectively or plan for long-term sustainability.

## Qualitative Findings

### Theme 1: The perceived strengths of Islamic microfinance

Respondents in BMTs and BPRS mentioned a well-fit of Islamic financing concept with local religious values. This fosters high levels of trust and acceptance among MSME customers. For instance, a BMT officer said, "A number of our members are too scared to borrow from mainstream banks because of interest. More directly, they are comfortable with Sharia-compliant contracts based on murabahah and qardhul hasan because that feels fairer and more transparent."

Islamic microfinance is also seen as more person-centered with emphasis on collaboration and social welfare and not only about profit. Many institutions may also provide repayment flexibility and focus on relationship-based rather than transactional interactions.

### Theme 2: The Work of BAZNAS in the Distribution of Productive Zakat

The Director of BAZNAS Garut, its employees, advocated the transformation of zakat distribution that adds to productivity for the sake of empowering the economic independence of *mustahik*. The BAZNAS programs, including Garut Makmur and some supporting fund *mustahik*, have a theme on the campaign to make sure that zakat can drive the people to be self-reliant (*mustadam*), and give demision for *mustahik* to become *muzakki* (paying zakat).

There are some success stories out there as BAZNAS combines religious giving and sustainable income generation:

1. A family in Tarogong Kaler, where they relied on unpredictable daily income, invested zakat-based capital to open a food stall that now consistently earns.
2. Business potential/support was demonstrated by the fact that one group in KWT Putri Sawargi group was able to have sales over Rp10 million in 3 days participating in Garut Festival 2022.

Interviews with BAZNAS showed that zakat, infaq, and sedekah (ZIS) integration fund, particularly for economic empowerment, still does not have the standards monitoring instruments. The vast majority of the projects are based on charity, with growing momentum toward having them serve as microenterprise incubators.

"We're not just giving [cash assistance] anymore," said one BAZNAS representative. We offer working capital, basic business training, and marketing support, particularly to women-led groups.

### Theme 3: Challenges in Implementation

Institutions, however, despite their dedication, are confronted with major challenges:

1. Poor financial literacy: A large number of MSME bear poor knowledge in the area of basic financial planning, which makes access to financing tough for them.

2. Misunderstandings about Sharia contracts: Various misconceptions about *murabahah* margins, including by some clients who mistakenly conflate the practice with interest (*riba*), have been holding back or alienating folk.
3. Institutional capacity: Smaller BMTs and units of BAZNAS can face staff shortages, little or no training, and lack of structured tools for monitoring.
4. Lack of SSBs on the ground which leads to internal desktop compliance checks.

#### Theme 4: Suggested Improvements

Interviewees suggested several recommendations to enhance impact:

1. Integrated mentoring programs alongside financing.
2. Strengthen Extension to Remote Areas and Ultra-micro enterprises.
3. To develop digital tools to increase efficiency and better monitor and communicate with MSME.
4. More synergy between BAZNAS and BMT/BPRS in addressing impact and developing incubation models.

“It’s not just a matter of providing capital. At least for the first year, we need to walk with them. That’s where a majority of MSME fail — there is a scarcity of support after money is given.”

The SWOT analysis of Islamic Microfinance in Rural can be found in the figure below:

Strong religious trust and social embeddedness High client satisfaction with ethical contracts <b>Strengths</b>	Low financial literacy among clients Limited monitoring and evaluation tools <b>Weaknesses</b>
<b>Opportunities</b> Integrated mentoring programs available Digital Islamic finance expansion (mobile <i>murabahah</i> apps)	<b>Threats</b> Misconceptions about Sharia contracts Economic shocks reducing zakat inflow

Figure 3. SWOT Analysis of Islamic Microfinance in Rural

#### Conclusion of Qualitative Findings

The qualitative findings also indicate that Islamic microfinance in Garut has a deep-rooted financial and cultural value. But its sustainability and lasting impact will be contingent upon the advancement and cultivation of institutions, ongoing support of entrepreneurs, and fostering of greater religious and financial literacy.

#### Synthesis and Theoretical Reflection: Discussion

Results validate Financial Inclusion Theory, as Islamic microfinance does indeed increase the reach of entrepreneurs and their business resilience. At the same time, the moral and faith-based element provided by *maqashid al-shariah* fosters trust and financial commitment from users— a comparative advantage over traditional microfinance. But sustainable impact is only achievable when financing is somehow integrated in business training, market access, and monitoring. BAZNAS's role is also becoming more strategic; it should move beyond providing ad hoc aid to enabling long-term economic empowerment through structured incubation and performance-based funding.

The findings of this research suggest that Islamic microfinance in Garut effectively enhances MSME growth through faith-based trust, social responsibility, and localized empowerment. However, sustainability requires continuous support mechanisms such as mentoring, digital inclusion, and financial education. Integrating productive zakat into MSME incubation aligns Islamic finance with national development priorities and SDGs 8 and 10. Government should foster stronger synergy among BAZNAS, BMTs, and government programs to institutionalize social enterprise models. Future research should expand sample coverage, employ econometric modeling, and compare regions to validate external generalizability.

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## APPENDIX

### Appendix 1. Survey Instrument Design (for MSME player)

#### Section A – Respondent Profile

1. Name (optional):
2. Age:
3. Gender:
4. Education level:
5. Type of business:
6. Duration of business operation (in years):

#### Section B – Financial Access

7. Have you ever received financing from Islamic microfinance? (Yes/No)
8. Type of institution: BMT / BPRS / BAZNAS / Others
9. Type of financing received:
  - Murabahah
  - Mudharabah
  - Qardhul Hasan
  - Other: \_\_\_\_\_

#### Section C – Impact of Financing

10. Has your monthly business income increased after receiving financing?
  - Yes
  - No
  - If yes, estimate the percentage increase: \_\_\_\_%
11. What were the funds used for?
  - Capital
  - Equipment
  - Marketing
  - Others: \_\_\_\_\_
12. Have you hired additional workers after receiving financing? (Yes/No)
13. Have you increased your production or service capacity? (Yes/No)

**Section D – Perceptions and Preferences**

14. How satisfied are you with the financing service you received? (Scale 1–5)
15. Do you prefer Islamic financing over conventional loans? Why?
16. Are the financing principles aligned with your religious beliefs? (Yes/No)
17. What are the challenges you faced in accessing Islamic finance?

**Appendix 2. Interview Questions (for BMT/BPRS/BAZNAS Officers)**

1. What types of Islamic financial products are most frequently used by MSME in your institution?
2. How do you determine eligibility for financing?
3. What monitoring or mentoring mechanisms are in place after disbursement?
4. What are the main challenges faced by your institution in serving MSME?
5. How do you ensure compliance with Sharia principles in your operations?
6. How do you measure the economic and social impact of your financing programs?
7. What is your view on integrating productive zakat with microfinance models?
8. What improvements would you recommend for Islamic microfinance in Garut?