

Opportunities and Challenges for Islamic Microfinance Institutions in Aceh

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ABSTRACT

This article examines the challenges and opportunities for Islamic Microfinance Institutions (LKMS) in supporting the strengthening of the Islamic financial system in Aceh following the implementation of Qanun No. 11 of 2018 concerning Islamic Financial Institutions. This study employs a qualitative approach, incorporating in-depth interviews, observations, and secondary data analysis of LKMS financial reports and institutional documents. The research findings indicate that regulatory support and the socio-religious context in Aceh create strategic opportunities for LKMS through a captive market, community preference for halal transactions, and the need for financing in the real sector, especially agriculture, fisheries, and MSMEs. However, the research also reveals significant challenges, including limited human resource capacity, weak capital, low Islamic financial literacy, and the continued dominance of loan shark practices at the community level. Furthermore, government programs that have not been integrated with the LKMS ecosystem add to the complexity of improving the competitiveness of these institutions. This study concludes that the success of LKMS in Aceh cannot rely solely on the existence of regulations, but requires strategies for institutional strengthening, product diversification, digitalisation of services, and increased Islamic financial literacy. The implications of this research emphasise the need for regional government policy support and collaboration with Baitul Mal and socio-religious institutions to create an inclusive and sustainable Islamic financial ecosystem.

Keywords: Islamic Microfinance Institutions (LKMS), Qanun, Islamic financial literacy, Islamic financial inclusion, Economic Empowerment

INTRODUCTION

Aceh holds a unique position in Indonesia's Islamic financial landscape. In addition to its strong socio-religious foundation, Aceh has implemented Aceh Qanun No. 11 of 2018 concerning Islamic Financial Institutions (LKS), which requires financial institutions in the region to operate in accordance with sharia principles. This Qanun establishes a clear legal framework for the development of Islamic financial institutions, while also driving institutional transformation at the regional level (Umuri et al., 2023). The implementation of the Qanun is expected to strengthen Islamic financial inclusion (Farma & Umuri, 2024), particularly for micro, small, and low-income households, which have traditionally been the primary targets of Islamic Microfinance Institutions (LKMS). However, the reality on the ground indicates that the adaptation process and its impact on poverty remain variable (Tamanni & Haji Besar, 2019).

Poverty in Aceh remains a significant issue, despite some improvements. The percentage of Aceh's poor population was recorded at 12.64% in September 2024 (a decrease compared to March 2024). However, this figure remains relatively high, indicating a series of economic vulnerabilities at the household level that require

appropriate financing interventions (Badan Pusat Statistik Provinsi Aceh, 2025). This situation confirms the central role of Islamic Microfinance Institutions (LKMS) as a channel for productive financing and financial protection, as well as an empowerment instrument with the potential to reduce economic vulnerability.

Despite the existence of a Sharia legal framework, the reality is that many Acehnese still access conventional microfinance institutions or informal mechanisms (loan shark practices) to meet their daily needs. Several studies have shown that low Sharia financial literacy leads people to continue using conventional financial services because they are perceived as faster, easier, and having a broader network (Adu-Ntim et al., 2024; Albaity & Rahman, 2019; Lorenza & Fasa, 2024; Mohieldin et al., 2015).

Aceh Province's transition to Sharia compliance presents classic challenges, such as ongoing costs and adaptation challenges, making it difficult to immediately comply with applicable regulations (Farma & Umuri, 2024). This situation highlights that the transition to Sharia finance in Aceh cannot be achieved simply through regulatory changes or the labelling of financial institutions; it requires the design of micro-products that are relevant to the real needs of the community. Islamic microfinance products must be easily accessible, flexible in implementation, and equipped with business assistance to avoid increasing the burden of adaptation for the community. Without a balance between Sharia compliance and the practical benefits of the product, the risk is that the Sharia financial transition will become merely a formality, neglecting the substance of improving access to finance, particularly for vulnerable groups (Aditya et al., 2025).

LKMS in Aceh face complex dynamics in fulfilling their strategic role as providers of financial access to the community, particularly those in the economically disadvantaged groups. On the one hand, the Qanun on Islamic Financial Institutions provides a strong regulatory foundation, offering opportunities for Islamic Financial Institutions (IFIs) to develop within a Sharia-compliant framework (Asyiqin & Rinaldi, 2025). This opens up potential for market expansion, increased public trust, and strengthens the identity of the Sharia-based economy in Aceh. However, on the other hand, real challenges faced include low Sharia financial literacy, limited human resource capacity, limited service network accessibility, and limited capital for business expansion (Farma & Umuri, 2024). These conditions often make it difficult for LKMS to compete with conventional financial institutions that offer faster, easier services and have more established infrastructure. Therefore, strengthening Islamic Financial Institutions (IFIs) requires a comprehensive strategy that focuses not only on Sharia compliance but also on product innovation, the use of digital technology, managerial capacity building, and financial literacy programs tailored to the socio-religious context of Acehnese society.

Beyond the challenges, LKMS in Aceh also face significant opportunities. The recently launched national Red and White Village Cooperative program, a movement aimed at strengthening village economies and alleviating poverty, presents strategic opportunities for synergy with LKMS in Aceh. This program aims to enhance access to inclusive financial services at the village level by establishing local cooperatives that receive mentoring and digitalization support. If implemented in Aceh, taking into account the context of Islamic law (Qanun), the Red and White Cooperative has the potential to become a crucial channel for integrating local cooperative practices with Islamic principles, expanding the LKMS distribution network, and accelerating the penetration of Islamic microfinance services.

However, successful integration requires institutional transformation, Sharia certification, and financial literacy training that is based on religious and cultural values.

Based on this overview, this study is crucial for mapping the challenges and opportunities faced by LKMS in strengthening their role in Aceh. Challenges include limited institutional capacity, low Sharia financial literacy, and the continued public preference for conventional and informal institutions. On the other hand, opportunities arise from the growing need for microfinance, regulatory support in the form of the Qanun LKS (Lending and Loans) and initiatives by local and central governments to promote Sharia-based financial inclusion. The study focuses on assessing the institutional capacity of LKMS, the behaviour and preferences of community users, and policy opportunities that can be optimized to enable LKMS to become a strategic instrument in driving economic development and poverty alleviation in Aceh.

LITERATURE REVIEW

Islamic Financial Institutions

Islamic Financial Institutions (IFIs) are financial institutions whose operations are based on Sharia principles, which prohibit elements such as usury (riba), gharar (gharar), gambling (maisir), and invalid contracts (Rismawati et al., 2023). LKMS are a financial system developed in accordance with Sharia. Efforts to establish this system are based on the Islamic prohibition on collecting or borrowing with interest, known as usury (riba), and the prohibition on investing in businesses categorised as haram (forbidden) (Grassa, 2013).

The characteristics of Islamic financial institutions encompass several essential aspects. First, fundraising and distribution must be based on a fatwa from the Sharia Supervisory Board (DPS). Second, the relationship between investors, fund users, and institutions is based on the principle of partnership, rather than a debtor-creditor relationship. Third, Islamic financial institutions are not only profit-oriented but also falah-oriented, emphasising worldly prosperity and happiness in the afterlife. Finally, Islamic financial institutions are only permitted to make investments that are halal and do not cause harm (Yusuf & Al Arif, 2015).

Financial institutions act as financial intermediaries between households and entrepreneurs, facilitating the development of savings and financing. In financial intermediation, Islamic financial institutions collect and distribute funds based on payment and repayment agreements. Financial institutions, including Islamic financial institutions, function as strategic intermediary entities. Their primary tasks involve asset transfer, liquidity management, income reallocation, transaction facilitation, and reducing transaction costs. By setting aside income and supporting future preparation, Islamic financial institutions create mechanisms that bring together those in need and make vital contributions to a more inclusive economy and public finances (Soemitra, 2017).

Islamic financial institutions were established to develop healthy financial entities based on efficiency and fairness (Soediro & Meutia, 2018). Furthermore, these objectives include increasing community participation to support people's economic enterprises, as well as the expansion of Islamic financial institutions throughout the region. Furthermore, Islamic financial institutions aim to enhance the Indonesian economy and reduce inequality by expanding business, creating employment opportunities, and increasing income (Risfandy et al., 2023).

Islamic Microfinance Institutions (LKMS)

Islamic Microfinance Institutions (IMFs) are micro-scale financial institutions that collect funds and distribute financing to low-income communities. IMFs' activities can be social (non-profit), such as distributing zakat, infaq, and sadaqah (charity), or commercial, such as providing business capital financing with a profit-sharing system (Jamaludin et al., 2023). According to Article 1 of Law Number 1 of 2013 concerning Microfinance

Institutions (MFIs), MFIs are financial institutions specifically established to provide business development and community empowerment services through loans or micro-scale business financing to members and the broader community. IMFs are a type of IMF that operates according to Islamic principles. In practice, LKMS apply Islamic values in daily economic transactions, namely transactions free from speculation (maysir), free from usury (riba), not hoarding wealth, and based on willingness, openness, and justice. Microfinance is a term used to describe the provision of financial services to communities in developing countries in various forms, such as personal loans, group financing, microloans, microcredit, microinsurance, and other financial instruments aimed at supporting high-risk businesses (Riaz & Qasim, 2016). In general, Islamic Microfinance Institutions (IMFIs), Non-Governmental Organisations (NGOs), and government agencies play a role in providing facilities designed to help those in genuine need, with support from various parties, including government and non-governmental organisations.

Conceptually, the term "Islamic Microfinance Institutions" encompasses all financial institutions that operate in accordance with Sharia principles. However, the term "micro" refers explicitly to institutions focused on small-scale financing and grassroots projects. Therefore, it is essential to consider various entities, including microfinance foundations, banks, small-scale financial institutions, regional institutions such as Baitul Maal wat Tamwil (BMT), sharia cooperatives, and Sharia People's Credit Banks (BPRS) (Mujiono, 2017).

RESEARCH METHOD

This research employed a qualitative approach, utilising descriptive analysis methods. Relevant data were collected to address the research questions through structured interviews with informants, including Aceh LKMS administrators, academics, and LKMS customers who have in-depth knowledge of Islamic microfinance institutions in Aceh. The collected data were then analysed using steps that included data reduction, data presentation, verification, and data triangulation to conclude (Miles & Huberman, 1994). The interview data were supplemented with secondary data to review the literature and develop a theoretical foundation directly related to the research problem or conceptual framework. This was accomplished through the use of reference books, research journals, articles, and internet searches, which involved accessing websites related to the research topic (Sugiyono, 2016).

RESULTS

An in-depth analysis of primary data, gathered through interviews with stakeholders (LKMS Management, academics, and customers), combined with secondary data from research reports, news articles, and scientific publications, reveals a complex, dualistic landscape for LKMS in Aceh. On the one hand, unique strategic opportunities exist, supported by regulatory and sociocultural foundations that are not available in other regions of Indonesia. On the other hand, fundamental structural challenges, both internal and external, significantly hamper the ability of LKMS to translate this potential into tangible impact on the community's economy.

Opportunities for Islamic Microfinance in Aceh

Aceh is one of the privileged regions in Indonesia with the formal implementation of Islamic law, including in the financial sector. Aceh Qanun Number 11 of 2018 concerning Islamic Financial Institutions requires all financial institutions to operate in accordance with Islamic principles (Umuri et al., 2023). This situation presents significant

opportunities for the development of Islamic microfinance institutions (IMFIs), such as BMTs (Islamic Business Units), Islamic cooperatives, and micro-waqf banks. The existence of LKMS is crucial because the majority of Acehnese people operate in the micro, small, and medium enterprise (MSME) sector, which requires access to capital (Maulana & Fitri, 2023). To date, some business owners face limitations in obtaining financing from formal institutions, so the presence of LKMS can provide a more inclusive, Sharia-compliant solution that meets the needs of local communities (Ayunda et al., 2025).

Opportunities for Islamic microfinance in Aceh are growing due to increasing public awareness of the need to avoid usury practices and opt for halal transactions. Sharia-based products such as murabahah, ijarah, and qardhul hasan have received a positive response, particularly among micro-entrepreneurs. Furthermore, the local government is encouraging the establishment of LKMS as an effort to reduce the prevalence of loan sharking in rural areas. Regulatory support, broad market potential, and the public's need for easy, Sharia-compliant financing make LKMS strategically positioned in Islamic economic development. However, challenges remain, particularly related to limited Sharia financial literacy and the need for innovative products to enhance competitiveness. Here are some opportunities for developing Islamic microfinance institutions in Aceh.

1. Sharia Regulation and the Formation of a Potential Market for Islamic Microfinance Institutions

The most significant and most fundamental opportunity for Islamic microfinance institutions in Aceh is Qanun No. 11 of 2018 (Majid et al., 2022). Not only is this legal instrument, but it also serves to affirm Aceh's political and cultural identity as a Sharia-compliant region. This provides Islamic microfinance institutions with unparalleled legitimacy. A senior LKMS administrator in Banda Aceh stated, "The Qanun enacted in Aceh provides strategic advantages for Islamic microfinance institutions, as it provides a clear legal basis and formal legitimacy for conducting operations in accordance with Sharia principles." This qanun not only eliminated conventional competitors but also granted us a 'halal label' from the highest authority in Aceh, which is highly valued by the public.

The direct impact of this qanun is the creation of a captive market, where the public is automatically bound to use Sharia-compliant microfinance services as the only legitimate option. Theoretically, all Acehnese who need microfinance services are potential customers of Islamic microfinance institutions. This creates an environment with virtually no external competition from formal conventional microfinance institutions, a luxury not afforded to Islamic microfinance institutions in other provinces (Nasrullah, 2020). This opportunity is further strengthened by the phenomenon of Islamic branding, where Muslim consumers show a higher preference for products and services with a precise and verified Islamic identity (Ahmed et al., 2022). In Aceh, this preference is no longer merely an option but a normative and legal obligation, facilitating customer acquisition and loyalty for Islamic microfinance institutions. The public trust built through this qanun's mandate represents invaluable social capital.

2. Specific and Untapped Financing Needs in the Real Sector

Aceh has enormous real economic potential, particularly in the agricultural sector, such as Gayo coffee, patchouli, and nutmeg, as well as in the capture fisheries and halal tourism sectors. These sectors not only have high economic value but also serve as the mainstay of local livelihoods. However, this potential is often hampered by limited access to financing tailored to the characteristics of their businesses. Conventional banking financing schemes, which are typically based on strict collateral requirements and fixed

monthly instalments, are often incompatible with the cash flow patterns of businesses in the real sector. As expressed by a coffee farmer in Bener Meriah, difficulties arise because farmers' income is only significant during the harvest season, whereas financial institutions require fixed monthly instalments. This creates both a psychological and financial burden for small businesses in rural areas.

This phenomenon illustrates a significant and strategic market gap, where the financing needs of the real sector are not fully met. Sharia Microfinance Institutions (LKMS) can play a vital role as a more inclusive and contextual solution. By adopting Sharia principles that emphasise justice (*al-'adl*), partnership (*syirkah*), and mutual assistance (*ta'awun*), microfinance institutions (LKMS) have the opportunity to design flexible and adaptive financing products. For example, through *mudharabah* or *musyarakah* contracts, LKMS can adjust payment schedules based on harvest cycles or fishing seasons, making instalment payments more realistic and less burdensome for customers.

Furthermore, LKMS can utilise profit and loss sharing mechanisms as a fairer and more productive financing alternative. This scheme enables the sharing of business risks between the institution and the customer, fostering a sense of community while strengthening socio-economic ties (Herlangga, 2021). Research shows that a profit-sharing financing model is more suitable for the small agribusiness sector, as seasonal income fluctuations can be more proportionally accommodated. Thus, LKMS becomes not only a funding provider but also a strategic partners in the development of real community businesses.

Furthermore, the potential development of the halal tourism sector in Aceh also presents opportunities for LKMS to explore creative financing options. For example, providing financing schemes for halal culinary businesses, community-based homestays, or religious ecotourism. These schemes can be linked to community-based microfinance, which provides greater participation for local communities. With this strategy, LKMS can expand their customer base while contributing to poverty reduction and sustainably improving community welfare. Furthermore, by closing the gap between the community's real needs and available financing products, LKMS have the potential to play a strategic role in Aceh's economic transformation. Their flexibility, fairness, and orientation toward productive sectors make them pioneers in building a financing ecosystem that aligns with local culture and economic realities.

3. Potential Synergy with Government Initiatives and Islamic Philanthropy

Governments, both at the central and regional levels, are increasingly launching financial inclusion and poverty alleviation programs. In Aceh, a recent initiative is the launch of the Red and White Cooperative, which the Aceh Government initiated to expand access to financing for low-income communities. In this context, the existence of LKMS should not be viewed as competitors, but rather as strategic partners. LKMS can position themselves as technical actors with the capacity, methodology, and experience to reach micro-segments that have previously been underserved by formal banking. Therefore, collaboration between Islamic financial institutions, government initiatives and Islamic philanthropy can create a more inclusive and sustainable ecosystem.

Interviews with LKMS administrators, academics, and customers suggest that synergy between LKMS and the government can be achieved through two mechanisms: channelling and execution. The channelling scheme positions LKMS solely as a fund distributor, while the executing scheme grants full authority, from recipient selection and distribution to business mentoring. Informants considered the executing scheme more promising because it allows for the application of prudential principles, adjustments to

local real sector needs, Sharia compliance, and ongoing mentoring, which enhances the substantive role of LKMS and program sustainability.

Furthermore, there is significant potential for integration with Baitul Mal Aceh, the official institution responsible for managing zakat, infaq, and alms (ZIS) in Aceh Province. Productive zakat funds from Baitul Mal can synergise with commercial financing funds from LKMS. For example, zakat can be directed to entrepreneurship training programs. This type of collaborative practice is also supported by international literature that emphasises the importance of synergy between Islamic microfinance institutions and Islamic philanthropy. (Ahmed et al., 2023) explain that the integration of zakat and Islamic microfinance can bridge the financing gap for the extreme poor, who are often unbankable despite their productive potential. In this way, social funds serve as risk-sharing mechanisms, while commercial funds provide growth capital. In the Aceh context, this model can accelerate the achievement of the Sustainable Development Goals (SDGs), particularly in reducing poverty (SDG 1) and promoting decent work and economic growth (SDG 8).

Thus, synergy between LKMS, the government, and Baitul Mal is not only a pragmatic strategy but also a necessity in strengthening the Islamic economic ecosystem. This collaboration will have a dual impact: expanding financial access for low-income communities while ensuring that Islamic values of social justice are implemented in the practical practice of economic development in Aceh.

Challenges of Islamic Microfinance in Aceh

Although the opportunities for developing Islamic Microfinance Institutions (IMFIs) in Aceh are significant, supported by regulatory backing, the potential for halal tourism, and the integration of productive zakat (alms), the reality on the ground reveals that many obstacles remain. Internal challenges include limited capital, limited human resource quality, and weak governance. Meanwhile, external challenges include low public financial literacy, the dominance of informal financial institutions such as loan sharks, and competition from digital institutions and new government initiatives. This situation creates a gap between regulatory ideals and the capacity for implementation. Here are some of the challenges facing LKMS in Aceh.

1. Internal Challenges: Unstable Institutional Structures of Islamic Microfinance Institutions (LKMS)

A human resource capacity crisis is a common thread running through almost all internal problems facing LKMS in Aceh Besar. A BMT manager in Aceh Besar frankly admitted, "Our human resources are mostly high school graduates or have a general degree. They understand how to record transactions, but when it comes to conducting in-depth feasibility analysis of customer businesses, designing innovative new products, or conducting digital marketing, we are far behind. We are like soldiers given sophisticated weapons (LKS Qanun) but not trained how to shoot."

The crisis has several interrelated dimensions, including the limited availability of human resources with a strong understanding of Islamic jurisprudence (fiqh) and modern financial literacy, such as risk management, data analysis, and financial technology. A dichotomy often exists between a deep understanding of Sharia and a weak understanding of business, or vice versa.

Furthermore, there is very little investment in employee training for Islamic Microfinance Institutions (LKMS) in Aceh. Existing training is often sporadic, theoretical, and

unsustainable. There are no vocational training institutions that systematically produce ready-to-use LKMS practitioners who meet the industry's needs in Aceh. Retention and compensation issues also pose challenges for MFIs in Aceh. Due to their small scale, LKMSs often struggle to offer competitive remuneration, making it challenging to attract and retain top talent (Romdlon et al., 2021). As a result, LKMSs are trapped in subsistence operations, reactive to problems, and unable to undertake strategic innovation.

Another challenge lies in stagnant product innovation, such as being stuck in a single contract (Murabahah). In theory, Islamic finance is rich in flexible and partnership-oriented contracts. However, in practice, field data shows that more than 80% of Islamic microfinance institutions (LKMS) financing portfolios in Aceh are still dominated by Murabahah contracts (sale and purchase with a profit margin) (Wardani, 2025). This over-reliance on a single contract type creates a "murabahah trap" that raises several serious problems. Furthermore, the fixed instalment scheme of murabahah is not suitable for specific sectors, such as farmers or fishermen with seasonal incomes. Murabahah products are highly susceptible to the risk of bad debt, making LKMS products inappropriate for their intended purpose.

Some people believe that the profit margin in murabahah contracts is not significantly different from conventional bank interest rates. This view creates confusion and even disappointment, as their expectations regarding the fundamental differences between Islamic and conventional institutions are not met. The testimony of an LKMS customer who stated, "It's the same, just a different name," reflects a serious problem in Islamic financial communication and literacy. If this perception is not immediately corrected, the Islamic missionary value, moral legitimacy, and unique appeal of mudharabah finance will be further weakened in the eyes of the wider community.

Another internal challenge is that the majority of Islamic microfinance institutions (LKMS) in Aceh are small-scale institutions (BMTs or Islamic cooperatives) with minimal core capital. This limitation is a significant barrier to scaling up. "We often have to reject financing applications from potential customers with good businesses, not because their businesses are unviable, but because our financing limits are insufficient to meet their capital needs," said a Sharia cooperative administrator.

The gap is widening in the technological realm, where fintech and illegal online loans (pinjol) can reach customers in remote villages simply through smartphone applications. At the same time, the majority of LKMS in Aceh still operate in a conventional manner. The absence of basic digital services such as mobile banking, online financing applications, or even integrated management information systems makes LKMS seem outdated, slow, and impractical, especially for the millennial and Gen Z customer segments (Nur'aini et al., 2023).

2. External Challenges: Multidimensional Competitive Dynamics

Interviews with various parties, from LKMS administrators to academics and customers, indicate that the external challenges faced by LKMS in Aceh are far more complex than limited capital or internal capacity. Informants emphasized that multidimensional competitive dynamics are a crucial factor in determining the sustainability of LKMS amidst an increasingly open economic landscape.

One of the biggest paradoxes raised concerns Islamic financial literacy. An academic from Banda Aceh stated, "Converting financial institutions to Islamic law is only the first step. However, what is far more difficult is converting people's mindsets. Many customers switch to LKMS or Islamic banks because of the Qanun (religious law), not because they

truly understand the concept." This view confirms that the public's understanding of Islamic financial products, risks, and benefits remains very low. Rather than adding value, this situation actually creates a vacuum that loan sharks exploit.

The practice of loan sharks, also known as mobile banks, remains prevalent even after the enactment of the Qanun on LKS. One customer in South Aceh recounted his experience: "If I need money urgently, I just call, and they will come within an hour. There are no complicated requirements, no collateral required, and the money is disbursed immediately. The interest is high, but what can you do, the money is fast." This experience demonstrates that speed, accessibility, and flexibility are the main competitive advantages of loan sharks, which LKMSs have yet to match. An LKMS administrator in Aceh Besar also admitted, "We're behind on service. Our process requires surveys and analysis, which sometimes takes several days. For urgent needs, people prefer shortcuts, even if it's detrimental to them."

In addition to competition from informal institutions, threats also come from government programs. The recent initiative of the Red and White Cooperative, which offers "interest-free" financing, is seen by some LKMS administrators as a real disruption. "If people already receive free capital from the government, why would they borrow from LKMS? Over time, they become dependent on assistance. This is dangerous because it kills the spirit of independence," said an LKMS association administrator in Central Aceh. This statement reflects concerns that government programs, if not appropriately managed, could weaken LKMS's competitiveness.

However, from an academic perspective, these government programs should not always be viewed as a threat. "LKMS shouldn't be passive. They must be proactive, offering themselves as technical partners in disbursing funds. The government has the budget, LKMS has the experience and microcredit scoring methodology. If synergized, the results could be much greater," explained a lecturer at UIN Ar-Raniry. In other words, disruption from the government can be turned into an opportunity for collaboration, but this requires the courage and ability of LKMS to build strategic communication.

Another external challenge, also emphasized by informants, is the weak role of local governments as mentors. An LKMS administrator in Banda Aceh said, "It feels like we've been left to fend for ourselves. The Qanun (law) is in place, but there's very little follow-up. There's no major program to improve human resource capacity, and no concrete support for access to capital. We need the government not just to create regulations, but to be the driving force." This complaint highlights that without consistent support and guidance, LKMS will struggle to develop in an increasingly competitive environment.

Overall, field interviews revealed that the external challenges facing LKMS in Aceh are multidimensional. On the one hand, they must confront the dominance of loan sharks with faster and more flexible services. On the other hand, they are required to respond to government policies and initiatives that have the potential to disrupt the market. Furthermore, low levels of Islamic financial literacy hinder the public's ability to understand the uniqueness and advantages of Islamic products fully. Without adaptive and collaborative strategies, LKMS risks losing its relevance, even within a formally Islamic financial ecosystem.

Thus, the dynamics of external competition for LKMS in Aceh are not simply about survival, but about the ability to adapt, innovate, and build strategic partnerships. As one academic emphasized: "The future of LKMS in Aceh is not determined by the qanun alone, but by their ability to read challenges, turn them into opportunities, and remain consistent with the principles of *falah*."

CONCLUSION

This study empirically analyses the challenges and opportunities for Islamic Microfinance Institutions (LKMS) in strengthening their role in Aceh, particularly following the enactment of Aceh Qanun No. 11 of 2018 concerning Islamic Financial Institutions. Through a qualitative approach based on interviews with LKMS administrators, academics, and customers, as well as secondary data, this study uncovered a dualism in the implementation of Islamic finance in Aceh.

The results indicate that regulatory support and the socio-religious context in Aceh create strategic opportunities for LKMS through a captive market, community preference for halal transactions, and the financing needs of the real sector (agriculture, fisheries, and MSMEs). Furthermore, synergy with government programs and the integration of Islamic social funds (zakat, infaq, and waqf) with microfinance have the potential to expand the role of LKMS as instruments of economic empowerment.

However, this study also highlights significant structural challenges. Internally, LKMS still faces limited human resource capacity, limited core capital, and stagnant product innovation, with the dominance of murabahah contracts, which lack flexibility for seasonal businesses. Meanwhile, externally, low Islamic financial literacy, the strong dominance of loan sharks offering fast and easy services, and the lack of effective coordination among government programs add to the complexity of competition among LKMS.

These findings suggest that the success of the Islamic financial transition in Aceh cannot rely solely on formal regulations, such as qanuns (Islamic law), but rather requires institutional strengthening, product innovation, and a deeper understanding of Islamic financial literacy. Furthermore, institutional integration between LKMS and the local government, Baitul Mal (an Islamic financial institution), and village cooperatives is crucial for creating a sustainable ecosystem of Islamic financial inclusion.

The implications of this research highlight the need for more proactive local government policies in fostering and strengthening LKMS, including increasing human resource capacity, providing capital support, and digitising services. For practitioners, these results emphasise the importance of contract diversification, adopting financial technology, and collaborative strategies in facing competition with informal institutions and government initiatives.

This research also opens the door for future researchers to expand the study, for example, by quantitatively analysing LKMS performance based on financing portfolios, the level of customer business sustainability, or the effectiveness of integrating Islamic social funds in economic empowerment. Sub-group analysis, such as a comparison of LKMS with high and low literacy levels, or LKMS with social and commercial orientation, can make a significant contribution in strengthening the role of LKMS as a strategic pillar of sharia economic development in Aceh.

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