

This report analyzes the progress toward commercialization of Indonesia's highly diversified and predominantly formal microfinance industry. It also explores the implications of commercialization and the remaining challenges to expanding outreach through commercial microfinance institutions (MFIs) facing various types of stakeholders (including microfinance clients, microfinance practitioners, the Government, and funding agencies). In addition, it recommends positive approaches to the expansion of commercial microfinance while preserving the traditional social objective of MFIs of expanding access by the poor to demand-driven, sustainable financial services.

METHODOLOGY AND ORGANIZATION

This study on which this report is based includes theoretical considerations drawn from the "financial systems" paradigm¹² and practical field experience for analyzing the commercialization of microfinance. The main findings and recommendations presented here are the product of extensive consultation through individual and group meetings with a wide variety of MFIs and stakeholders including microfinance clients, government officials, state-owned commercial banks, private banks, cooperatives, domestic and international nongovernment organizations (NGOs), funding agencies, and academics. In addition, because of the extreme diversity and numbers of MFIs operating at the village level throughout Indonesia, this study relies heavily on existing microfinance literature.

Responses to questionnaires eliciting stakeholder views on microfinance commercialization and their latest institutional and financial data have been incorporated

where possible. In addition to collecting such data and holding a wide variety of stakeholder meetings in Jakarta, the authors also gathered data during field visits to several other provinces.¹³ It is important to note that all institutional and financial data are based on self-reporting by the MFIs surveyed by the authors, unless otherwise noted. Readers should be mindful that these self-reported data provided by MFIs and included in this report are often based on estimates only. This is particularly an issue with NGOs providing microfinance (microfinance NGOs) that do not separate microfinance from other social programs or from traditional financial intermediation (as with many banks and cooperatives).

The remainder of this chapter elaborates on the framework for analyzing the commercialization of microfinance used throughout the study and establishes the country context as it affects the microfinance industry. Chapter 2 examines the historical development of the microfinance industry, evaluates major commercial MFIs and microfinance programs, and assesses MFI access to commercial sources of funds. Chapter 3 analyzes the conduciveness of the operating environment to the commercialization of microfinance by focusing on enabling attributes of the policy environment and the legal and regulatory framework, and the existence of key microfinance support institutions. Chapter 4 explores the implications of commercialization in terms of expected changes in access to microfinance by client type, in the mix of microfinance products and services offered, and in access to commercial sources of funds. Empirical evidence of and potential for competition and mission drift are also assessed in Chapter 4. Current challenges to microfinance commercialization are the focus of Chapter 5, which reveals stakeholder perceptions, internal constraints facing MFIs, and external

impediments in the operating environment. Chapter 6 recommends positive approaches to commercialization for the Government, funding agencies, various types of MFIs, and microfinance support institutions.

FRAMEWORK FOR ANALYZING MICROFINANCE COMMERCIALIZATION

There is general acceptance of many of the principles associated with commercialization, but use of the term causes discomfort among many Indonesian stakeholders, who associate commercialization with taking advantage of the poor for the sake of profit. While in practice, the microfinance industry is dominated by commercial players and institutional sustainability is generally accepted as a prerequisite for the expansion of outreach (the substance of commercialization), terminology remains an issue. Most practitioners prefer to use the term *business orientation* to reflect the positive aspects of commercialization. The term *commercialization* in Indonesia carries a negative connotation and is perceived more to indicate excessive profitability than sustainability. This concept of commercialization is distinct from the favorable one held by many microfinance professionals worldwide.

International microfinance professionals are increasingly considering commercialization to be “the application of market-based principles to microfinance” or “the expansion of profit-driven microfinance operations.”¹⁴ There is a growing realization in the international arena that commercialization allows MFIs greater opportunity to fulfill their social objectives of providing the poor with increased access to an array of demand-driven microfinance products and services. In Indonesia, however, euphemisms such as “surplus” are traditionally used in place of “profit” and institutional sustainability is used as an acceptable catch-all phrase indicating many of the principles of commercial microfinance elaborated in this study. Few Indonesian stakeholders hold the

view that commercialization allows MFIs greater opportunity to fulfill their social objectives of providing the poor with increased access to an array of demand-driven microfinance products and services (including not only credit but also savings, insurance, payments, money transfers, etc.).

This country study adopts a more comprehensive view of microfinance commercialization than is currently considered in Indonesia. It analyzes commercialization at two levels, proposing that it involves both institutional factors (MFI commercialization) and attributes of the environment within which MFIs operate (commercialization of the microfinance industry).

MFI Commercialization

MFI commercialization is considered as progress along a continuum, as depicted in Figure 1.1 and described below.

- Adoption of a professional, business-like approach to MFI administration and operation, such as developing diversified, demand-driven microfinance products and services and applying cost-recovery interest rates.
- Progression toward operational and financial self-sufficiency by increasing cost recovery and efficiency, as well as expanding outreach.
- Use of commercial sources of funds; for example, nonsubsidized loans from apex organizations (wholesale lending institutions) or commercial banks, mobilization of voluntary savings, or other market-based funding sources.
- Operation as a for-profit, formal¹⁵ financial institution that is subject to prudential regulation and supervision and able to attract equity investment.

Progress toward MFI commercialization is usually hastened by a strategic decision of an

MFI's owners/managers to adopt a for-profit orientation accompanied by a business plan to operationalize the strategy to reach full financial self-sufficiency and to increasingly leverage its funds to achieve greater levels of outreach. The recognition that the key to achieving substantial levels of outreach is building a sound financial institution, essentially means that MFIs need to charge cost-covering interest rates and continually strive for increasing operational efficiency.

Advocates of this approach rightly argue that charging cost-covering interest rates is feasible because most clients would have to pay, and indeed do pay, even higher interest rates to informal moneylenders. MFIs that charge cost-covering interest rates are an attractive option for this clientele even though the interest rates that an MFI might charge may seem high relative to the corresponding cost of borrowing from a commercial bank. The relevant basis for interest rate comparisons in the eyes of the client is the informal sector where he or she usually can access funds, not the commercial banking sector, which rarely serves this market.¹⁶

As an MFI's interest and fee revenue covers first its operating costs and then the cost of its loanable funds, it may be considered to be increasingly operating on a commercial basis. MFI profitability enables expansion of operations out of retained earnings or access to market-based sources of funds. Operating as a for-profit, formal financial institution may be the most complete hallmark of MFI commercialization because this implies subjectivity to prudential regulation and

supervision and that the MFI has become fully integrated into the formal financial system. However, MFIs strive for varying degrees of commercialization; not all aim to become formal financial institutions. This decision is usually closely linked to a host of external factors affecting the commercialization of microfinance, discussed next.

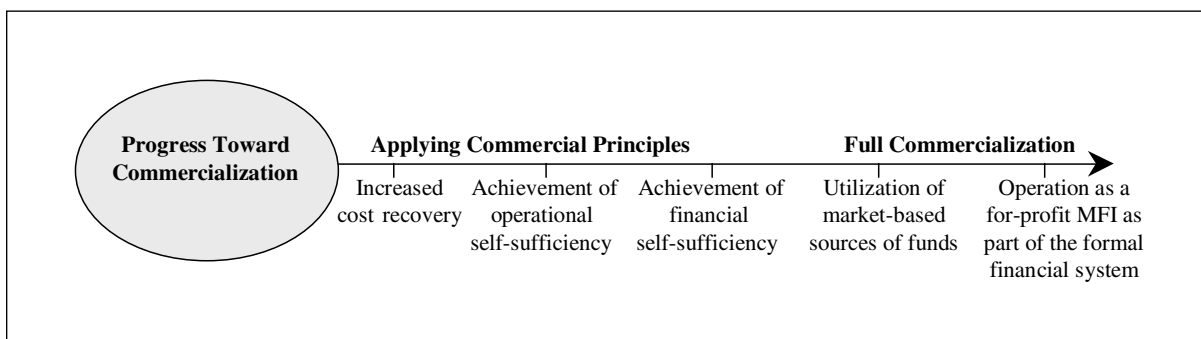
Commercialization of the Microfinance Industry

Commercialization of the microfinance industry involves several factors including the degree to which the policy environment is conducive to the proliferation of commercial MFIs, the extent to which the legal and regulatory framework supports the development and growth of commercial MFIs, the availability and access of commercial MFIs to market-based sources of funds, and the existence of key support institutions. The main elements of the operating environment that determine the commercialization of the microfinance industry can be divided into the following five categories.

1. Policy Environment

- Government policies that impede the ability of MFIs to progress toward commercialization (examples of such policies are interest rate caps and selective, ad hoc, debt-forgiveness programs).

Figure 1.1: Attributes of MFI Commercialization



- Subsidized (government or donor-supported) microcredit programs that may inhibit the development and growth of commercial MFIs.

2. Legal Framework

- The legal framework for secured transactions (the creation [legal definition], perfection [registration], and repossession [enforcement] of claims) as well as for microenterprise formation and growth.¹⁷
- The licensing options available to new MFI entrants or semiformal MFIs interested in transforming into formal financial institutions.

3. Regulation and Supervision

- The prudential regulations and supervision practices that govern MFIs mobilizing voluntary public deposits specifically or financial institutions in the broader financial markets generally, and the institutional capacity of the regulating body to carry out its mandate effectively.

4. Money Markets and Capital Markets

- Availability and access of MFIs to commercial sources of funds, such as nonsubsidized loans, from apex organizations (wholesale lending institutions) or banks; mobilization of voluntary savings, private investment funds, or other market-based funding sources.

5. Support Institutions

- Existence of credit information collection and reporting services, such as credit information bureaus and credit rating agencies, that capture information useful to MFIs regarding borrower creditworthiness, loans outstanding, types of collateral pledged, etc.; or to potential MFI investors. Examples include ratings of MFIs based on their portfolio quality and asset values, microfinance trade

associations and networks, local microfinance technical assistance providers and training institutions, and domestic providers of business development services.

NATIONAL CONTEXT

Socioeconomic development and macroeconomic and sectoral stability are important considerations in determining suitability of the operating environment to promote growth of the microfinance industry and its possible commercialization. This section presents the social development indicators for Indonesia, its recent macroeconomic performance, and that of the country's agricultural and financial sectors as a basis for establishing the national context for the commercialization of microfinance.

Socioeconomic Indicators

Population, Geography, and Infrastructure Development

The world's largest archipelago, Indonesia has a total population of about 214 million people¹⁸ inhabiting around 6,000 islands (out of a total of over 17,000). With a total land area of 1.8 million square kilometers (km²), Indonesia has a deceptively low population density ratio of about 117 people per km². However, the three most populous islands of Java, Bali, and Madura support more than 60% of the country's population on less than 10% of the land mass.¹⁹ This difference in population density contributes to distinctions between the three larger "inner islands" and all the other, smaller "outer islands" in terms of provision of physical infrastructure and social services. This uneven distribution of population and infrastructure contributes to significant differences in effective demand for microfinance between and within regions and in terms of the cost structures for MFIs. Hence, to provide microfinance on a commercial basis, one has to adapt products and services to local demand and adjust interest rates to reflect the costs of doing business in a particular area.

Social Indicators and Poverty

According to the United Nations Development Programme (UNDP) 2002 Human Development Report, Indonesia is classified as a “medium-level country” and it ranked 110 out of 173 countries.²⁰ Reflecting decades of significant economic and social investment by the Government, UNDP’s Human Development Index for the country rose from 0.591 in 1985 to 0.684 in 2000 and most social development indicators reflect similar positive trends (see Annex 1 for detailed data). However, while Indonesia’s progress in key social indicators, such as contraceptive use rate and child mortality, was good, it has lagged behind in others, such as secondary school enrollment, maternal mortality, and communicable diseases.²¹ Most human development indicators are commensurate with those of other East Asian countries; however, the Asian financial crisis²² of 1997–1998 arguably hit Indonesia hardest and the adverse social effects of it, such as decreased school enrollments and stubbornly low health indicators, linger. In addition, the higher Human Development Index masks persistent gender inequalities. Female illiteracy is still considerably higher than male illiteracy (20% and 9%, respectively), although the gap has narrowed considerably. Women remain concentrated in low-skill, low-paid employment. Of workers officially recorded as “unpaid family workers,” 71% are women. Home-based workers, who are predominantly women, are deprived of basic rights, benefits, and job security; and wages are usually extremely low.²³

The Government managed to decrease the proportion of the population living in poverty over the last 20 years from 40.1% in 1976 to around 17.6% or 34 million people in 1996.²⁴ At the peak of the crisis, however, the Asian Development Bank (ADB)²⁵ estimated that perhaps an additional 15 million people fell below the poverty line, showing the vulnerability of poor and near-poor households to economic shocks. The proportion below the poverty line stood at 18.2% in 1999 (Annex 1). Box 1.1 provides a profile of the poor, who are mostly uneducated, rural laborers. While the informal sector of the

Box 1.1

Characteristics of Indonesia’s Poor

- Only 5% of the poor have a secondary education or better—87% live in households in which the head of the household has only a primary education or less.
- For almost 60% of the poor, agriculture provides the main source of income (whether from labor or land).
- More than 75% of the poor live in rural areas.
- Most of the poor (61%) live on Java.
- Nearly 80% of the poor (and 50% of the nonpoor) lack access to improved water sources. Access to sanitation is even more limited.

Note: Figures are based on 1999 data.
Source: World Bank 2001, p6.

economy was estimated to include about 50 million microentrepreneurs before the crisis, it is widely believed to have expanded due to the influx of laid-off workers trying to earn income through self-employment.²⁶

While access to microfinance was important before the crisis, especially for women, MFIs over the last few years have become even more significant because traditional commercial lending was severely curtailed by the collapse of the banking sector in the late 1990s. Given the importance of the informal sector, access to commercial microfinance, especially microsavings, has provided a valuable social safety net for the poor and near poor, and helped many people start businesses. Because of this, commercial microfinance is increasingly lauded for supporting the resilience of the national economy during the crisis and at present.²⁷

Policy Priorities and Economic Growth

Continuing the economic recovery from the Asian financial crisis is the Government’s first priority. Related, chief concerns of the Government, which transitioned to a democracy

in 1999 after 4 decades of authoritarianism, are addressing charges of government corruption and cronyism and resolving growing separatist movements in several parts of the country. Increasing security threats and unease about the Government's slow pace of International Monetary Fund-mandated economic reforms have contributed to heightened investor uncertainty and weakened foreign direct investment.

Real gross domestic product (GDP) growth fell to 3.3% in 2001 from a strong 4.9% in 2000.²⁸ Although inflation spiked during the Asian financial crisis, it has remained relatively low and stable over the last 3 years (detailed economic indicators are included in Annex 2). Increases in private consumption and public expenditure accounted for most of the GDP growth in 2001, offsetting emerging weaknesses in business investment and external markets.²⁹ Income growth in 2000 signaled the end of the long recession stemming from the crisis. Solid wage increases followed for manufacturing and service sector employees. Large increases in minimum wages in 2000 and 2001 encouraged spending by some families. Gross national income per capita in 2001 was \$680 (using the Atlas method) but this average figure masks significant disparities³⁰ between low- and high-income families.

Rural populations, suffering from stagnant agricultural productivity, and those in the large informal sector saw little income growth.³¹ While real GDP growth was higher than that for many other countries in the region, it was not adequate to provide jobs for new entrants of the labor force. The unemployment rate in 2001 increased to an estimated 6.7–7.0% compared with 6.1% in the previous year. With a labor force growing at about 2.7% per year, Indonesia's economy will need to grow even faster to reduce poverty.³² Continued economic recovery from the Asian financial crisis and maintenance of low and stable inflation will be essential ingredients to allow expanded MFI provision of commercial microfinance.

Agriculture Sector Development

The rural sector contains the largest segment of the poor and almost 60% of the poor rely on agriculture for their main source of income. Agriculture provided employment for more than 43% of the labor force in 1999, and agriculture and natural resources are the basis for much manufacturing, especially for export markets.³³ However, agriculture as a share of GDP is declining, falling from 23.4% in 1981 to 16.4% in 2001.³⁴

Although agriculture's share of the economy is small compared to that of industry (which was 46.5% of GDP in 2001), increased agricultural productivity during the 1980s "created many opportunities for informal off-farm economic activities with consequent burgeoning demand for microfinance in the rural economy, especially on Java and Bali."³⁵ Agricultural growth in Indonesia averaged about 3.8% annually in the 1980s, approximately 2% higher than the rate of rural population growth. Between 1990 and 1995, however, the rate of agricultural growth slowed to 2.9%, and was negative during the Asian financial crisis and under the impact of successive occurrences of the El Niño weather pattern. The labor productivity (and income) gap between the agriculture and nonagriculture sectors widened over that period, contributing to increases in poverty. Per capita GDP in the nonagriculture sector in 1995 was almost five times higher than in agriculture.

The decline in average farm size and the low level of capital available to such small farms are major problems that complicate efforts to improve agricultural productivity. Other major constraints to agricultural development include old technologies, inadequate resources, deficient infrastructure, weak social capital, and a constraining policy and institutional environment.³⁶ Nevertheless, these issues must be addressed to ensure that appropriate farming systems are developed to realize the comparative advantages of the diverse localities of Indonesia.

Increasing agricultural productivity as part of a general rural development program is the key to opening many isolated areas to development. Sharply altered terms of trade since 1997 suggest greater opportunities for export-oriented crops. Technology transfer, raising the productivity of agriculture, and rural nonfarm activities can lead to diversified agriculture in line with contemporary terms of trade and production costs.³⁷ Investment to raise agricultural productivity holds the potential for increasing the effective demand for microfinance (in terms of both microcredit and microsavings) by agribusinesses, thereby expanding the market base for commercial MFIs interested in exploring new client niches.

Financial Sector Development

Composition of the Formal Financial Sector

Indonesia's formal financial system is composed of banks and nonbank financial institutions (NBFIs). The Ministry of Finance and the central bank—Bank Indonesia (BI)—are the primary government bodies regulating and supervising Indonesia's financial system and institutions, including banks. The Ministry of Finance's principal responsibilities are to establish banking sector policies and exercise financial management on behalf of the Government. BI's main functions are to maintain currency stability, issue new bank licenses, establish prudential regulations for banks, regulate the payments system, and conduct interbank clearing and settlement.

The Banking Act No. 7 of 1992 recognizes two types of banks: commercial banks, or primary banks permitted to offer the full range of banking services; and secondary banks, the *Bank Perkreditan Rakyat* (literally, "people's credit banks," usually translated as "rural banks" and identified as BPRs), with services limited to the provision of credit, savings, and time deposits. At the end of 2001, there were 145 commercial banks with a combined number of bank offices at 6,765.³⁸ Five state-owned banks controlled half the total banking sector assets. The total number

of BPRs was 7,703 with 81 of them operating under Sharia (i.e., Islamic banking) principles.³⁹ In addition, there are two types of NBFIs: those engaged primarily in capital market activities and the rest—finance companies, venture capital companies, insurance companies, and pension funds. The former are regulated and supervised by the Capital Market Supervisory Agency (*Bapepam*), while the latter are supervised by the Ministry of Finance with assistance in some cases from BI.⁴⁰

Continued Recovery of the Banking Sector

The Asian financial crisis was most dramatically reflected in Indonesia in the breakdown of the banking sector, with many banks being liquidated and most of the others surviving only as a result of a massive restructuring program implemented by the Government. An important early move by the Government in January 1998 was its blanket guarantee of deposits and creditor claims. Guaranteed bonds amounted to Rp164.5 trillion in 1998 alone (\$20.6 billion).⁴¹

The restructuring program as a whole essentially saved the industry from complete collapse through the issuance of Rp432 trillion (\$54 billion) of government obligations in total from the end of 1998 through October 2000. Since the crisis, several institutions have been established to help the two monetary authorities manage the bank restructuring and the recovery of nonperforming loans. These new institutions include the Indonesian Bank Restructuring Agency (IBRA) and the Assets Management Unit, which is a part of IBRA. In addition, an independent agency is supposed to be established soon to focus specifically on the supervision of the banking system.

Extensive restructuring and recapitalization of banks following the financial crisis have helped the banking system become more stable and financially healthy. Initial steps have also been taken toward reducing government ownership of banks and encouraging the recovery of lending to support economic activity. The Government provided support to recapitalize state-owned and

other selected banks throughout 1999 and 2000 to achieve a minimum 4% capital adequacy ratio (CAR). Following that, BI required all banks to meet a minimum 8% CAR by end-2001. Most of the 151 commercial banks achieved this target. Some of those that did not are being encouraged to merge with stronger institutions. BI aims to reduce the level of nonperforming bank loans eventually to a maximum of 5%. Despite some concerns regarding the consistency of asset classification between banks, the overall bank nonperforming loan ratio declined from 18.8% at end-2000 to 12.1% at end-2001.

Bank recapitalization has left most of the largest banks with a substantial portion of their assets in government recapitalization bonds, and loan portfolios substantially reduced following the transfer of selected nonperforming loans to IBRA. The loan-to-deposit ratio of all banks fell from more than 100% in 1997 to only 36% at end-1999. Lending, however, recovered somewhat

during 2001: bank credit grew 33%, albeit from a low post-crisis basis, and the overall loan-to-deposit ratio had risen to 45% by end-2001.⁴² Reflecting reduced inflation and continued recovery of the economy, the weighted, average interest rate of 1-month BI certificates continued to decrease in 2002, dropping from 15.11% in the second quarter to 13.22% in the third quarter. The interbank overnight interest rate also declined about 1.51% to 12.62%. These rate cuts were also followed by a gradual decline in time deposit rates and bank lending rates.

While Indonesia has made good progress in restructuring and recovering from the banking crises of the 1990s, it still has a way to go before there will be profitability and significant competition in the banking sector. Until then, the formal banking sector will likely continue to stay away from direct lending to microenterprises or small businesses or supporting MFIs through loans or refinancing facilities.