3 Conduciveness of the Operating Environment

The Indonesian microfinance industry has developed within an operating environment that has many elements conducive to the development and growth of commercial MFIs. This chapter highlights attributes of the policy environment, legal and regulatory framework, and support institutions that have promoted the commercialization of microfinance.

ENABLING POLICIES

Financial sector deregulation, begun in the early 1980s, liberalized interest rates and set the stage for the transformation of BRI's Units into a self-sufficient microfinance operation. Faced with a significant decline in the real value of oil revenues in the early 1980s and the need to create more than 2 million jobs annually, the Government in 1982 began a series of "deregulation and de-bureaucratization" reforms to deregulate the economy, particularly the banking sector. The twin goals were to give greater freedom to the private sector and reduce dependence on petroleum as a source of export earnings and tax revenues.[100] One of the most important first steps Indonesian policymakers took to provide a conducive operating environment for commercial MFIs was to liberalize interest rates in 1983, which set the stage for MFIs to charge cost-recovery interest rates and maintain spreads that allowed for profitability. Other important financial reforms of 1982/83 included BI's decrease of liquidity credits to some low-priority sectors, substantial reduction in the supply of directed credit to the public, and elimination of quantitative controls on bank lending.

High-level political support was needed for these banking sector reforms and for the 1983/84 transformation of the institution that has become the leading force for commercial microfinance in Indonesia and the world, BRI. "Economic ministers at the time made it clear that large-scale commercial microfinance would be of exceptional benefit to the economy and society, and that interference in the process of its development would not be tolerated."[101] The most fundamental change in policy regarding the BRI Units was a shift in management focus from disbursing credit to motivating loan recovery and savings mobilization, i.e., genuine financial intermediation. Moreover, to broaden and diversify its clientele, the Unit system began to target the low-income, rural population in general, rather than focus exclusively on farmers. The transformation of the BRI Unit system from a highly subsidized program for direct agricultural credit disbursement to a commercially-oriented bank focused on micro and small-scale lending allowed the expansion of microfinance services to 27.0 million savers and 2.8 million borrowers by end-2001.[102]

APPROPRIATE LEGAL AND REGULATORY FRAMEWORK

Tiered Licensing and Regulation

A tiered legal and regulatory framework stemming from the 1988 banking reforms allowed the expansion of unit (rural) banks, which was conducive to commercial microfinance operations throughout Indonesia. The series of reforms begun in 1988, collectively referred to as PAKTO, removed most banking industry entry barriers, allowing commercial banks to extend their branch networks throughout Indonesia. This reform package was successful in its goal of expanding the outreach of financial services to rural areas. The number of commercial banks

rose from 171 in 1990 to 240 in 1995 and the number of their branches increased from 3,563 to 5,191 during the same period.

The Government also permitted the establishment at the subdistrict level of new secondary banks with paid-up capital of only Rp50 million (equivalent to $6,250 at end-1998). More than 1,000 new BPRs were established during the following 5 years. The Banking Act of 1992 finally recognized BPRs as secondary banks, while Presidential Decree No. 71 of 1992 required LDKPs to seek a BPR license until October 1997. Of the LDKPs, 630 converted to BPRs between 1994 and early 1999 and these transformations account for almost two thirds of the BPR industry's growth during that time. In addition, the 1989 banking reform package allowed BPRs to open branches in other subdistricts outside the national, provincial, and district capitals; to upgrade or merge with commercial banks; and to merge with other BPRs.[103]

The new BPR regulations issued by BI in May 1999 substantially changed the framework for both BPR and nonbank MFIs in an attempt to strengthen them significantly. Government regulation No. 30 of 1999 declared Decree No. 71 of 1992, in which capital and conversion requirements had been stipulated, to be invalid. The regulation itself was to become valid when new BPR regulations were in place. BI issued these decrees separately for conventional and Sharia BPRs on 15 May 1999. Article 2 stipulates that BPRs may only be established and operated with a BI business license. Article 3 determines three legal forms for BPRs (limited liability, cooperative, and regional government enterprise), thus omitting the "other " category mentioned in the Banking Act. BPRs may not have foreign shareholders and Article 4 changes the capital requirements. The minimum paid-up capital increased to Rp2 billion ($223,714) for the greater Jakarta area, to Rp1 billion ($111,857) for provincial capitals, and to Rp500 million ($55,929) for other areas.[104]

Other special regulations offer provisions for fit and proper tests, credit restructuring, short-term financing, and bond portfolio trading. A set of BI decrees, such as for loan loss provisioning, minimum capital requirements, assessment of asset quality, lending limits, and financial reporting, was implemented to improve prudential banking practices in accordance with international standards. Compliance-based supervision was complemented with risk-based supervision in accordance with international standards.[105] BI's efforts to improve the effectiveness of bank supervision are reflected in the fact that the Senior Deputy Governor was appointed to oversee and coordinate the bank's supervision function.

Support for Sharia Banking

Recent regulations accommodating bank operations based on Sharia principles (Islamic banking) hold promise to open up access to microfinance services for a new and potentially significant subset of the population that may have historically shied away from microfinance because of cultural or religious reasons.[106] Act 10 of 1998 and Act 23 of 1999 have mandated and given legal basis for BI to develop Islamic banking in Indonesia, the world's most populous Muslim country. With Sharia banking, the lender-borrower relationship in the conventional bank approach is replaced by equity and risk sharing between a capital provider and an entrepreneur. The development of a legal and regulatory framework to support banking based on Sharia principles may help to shift focus from traditional collateral requirements to the merits of business proposals as a basis for lending decisions.

To develop Sharia banking, a number of problems need to be tackled. Incomplete regulations and financial infrastructure for Sharia banks are two basic problems that need to be addressed immediately. Relatively low public understanding of the operations of Sharia banking and the limited availability of experts in Sharia banking are also challenges. Another challenge is to make sure that Sharia banking is promoted in a way that complements traditional banking services without diminishing the credibility of traditional banks.

The relatively limited office network of Sharia banks implies limited service for customers who

desire Sharia banking services. The international Sharia banking community is currently working on two initiatives: a) establishment of an international financial market, which is expected to support the efficient management of funds internationally and is currently being finalized; and b) 18 member countries of the International Monetary Fund are preparing the establishment of the Islamic Financial Services Organization, an international institution that will issue prudential regulations for Sharia banks.

BI policies to deal with these issues are based on "fair, gradual, sustainable, and market-driven" principles that are consistent with Sharia principles and international standards. Within the short term (2002–2004), the objective is to position Sharia banking so that it becomes a practical alternative to conventional banking. For the medium term (2004–2008), the objective is for Sharia banks to take a more active role in promoting the productive sector. The long-term objective (2006–2011) is to make Sharia banks more efficient and able to operate internationally.[107]

Strengthening BI and Improving Bank Supervision

The deregulation of the banking sector begun in 1983 was not accompanied by adequate bank supervision; BI lacked the capacity to cope with the rapidly growing banking industry, especially in the late 1980s. BI also lacked independence and enforcement power. While BI and the state banks were prompted to take unsound credit decisions in favor of specific business groups and economic sectors, private banks connected to large business conglomerates failed to comply with legal lending limits regarding loans to their own shareholders. By the mid-1990s, several banks were on the brink of bankruptcy and it is only because of the Asian financial crisis in the late 1990s that major reforms are now being implemented.

Since 1998, the Government has been endeavoring to significantly strengthen BI, enhance prudential regulation and supervision of the banking sector, and improve the legal and regulatory framework for microfinance. Banking Act No. 10 of 1998 amended Banking Act No. 7 of 1992 and with it substantial changes were introduced, including the transfer of licensing authority from the Ministry of Finance to BI; the lifting of foreign bank ownership restrictions; the limitation of bank secrecy to information on deposits; and provisions for the formation of a deposit protection institution and the bank restructuring agency. Other special regulations dealt with fit and proper tests, bank mergers and acquisitions, revocation of business licenses, and bank liquidation. Compliance-based supervision was complemented with risk-based supervision and a set of BI decrees on loan loss provision requirements, minimum capital requirements, assessment of asset quality, legal lending limits, and financial reporting was made to improve prudential banking practices in accordance with international standards.[108]

Article 34 of Banking Act No. 23 of 1999 concerning BI mandated that there should be a new institution for consolidating supervision of the financial sector. In accordance with this mandate, the bank supervision function will be transferred from BI to this new independent institution, which will likely be established in 2003. With the transfer of this supervision function, BI will concentrate on monetary and payment system issues. The new supervisory institution will put more emphasis on effectively enforcing bank compliance with prudential regulation and NBFI regulation and supervision. It is planned to be a government institution outside the cabinet and accountable to the President. The objective of the institution will be to supervise all financial service institutions "in the framework of creating a healthy, accountable, and competitive financial services industry."[109] The coverage of the institution will include the supervision of banks and all NBFIs, such as insurance companies, venture capital companies, pawn companies, leasing companies, pension funds, security companies, and other financial service companies, including those mobilizing deposits from the public.

Several types of MFIs, such as BKDs, LDKPs, and other NBFIs (without bank licenses or registration as cooperatives), mobilize public

deposits in violation of the Banking Act. In order to address this issue and provide a legal basis for small-scale MFIs to operate under appropriate, adapted prudential regulation and supervision, a team supported by the ProFI project has been formulating a draft MFI Act since March 2001. The team is comprised of representatives from the Coordinating Ministry of Economics, Ministry of Finance, Ministry of Cooperatives, Ministry of Home Affairs, Ministry of Agriculture, BAPPENAS, BRI, and *Gerakan Bersama Pengembangan Keuangan Mikro Indonesia* (GEMA PKM, or the Indonesian Movement for Microfinance Development) microfinance network. An initial full draft of the microfinance law was sent to the Ministry of Finance for consideration in September 2001 and several revised versions have since been receiving consideration. Debates continue around whether regulation of microfinance should be activity-based or institutionally focused and which institution will ultimately regulate and supervise the MFIs falling under the proposed law.

EXISTENCE OF KEY SUPPORT INSTITUTIONS

Several key industry support institutions have assisted the commercialization of a wide variety of MFIs. These include GEMA PKM as the most inclusive national microfinance network; bankers associations, such as *Perbarindo*; and BK3I, the national apex organization for cooperatives. Each is contributing significantly to the commercialization of microfinance in different ways, as described below.

GEMA PKM includes representatives of the Government, NGOs, financial institutions, the business sector, universities, and research institutes. The State Minister for the Empowerment of Women and Head of the National Family Planning Coordination Board heads the organization, while leading NGOs, such as *Bina Swadaya*, appear to be the driving force. Although it was established only in March 2000, the network is an active partner in the drafting of a Microfinance Act and is committed to promoting awareness and adoption of best practices in microfinance as a tool for poverty reduction and economic growth. The declaration of GEMA PKM demands substantial changes in economic development strategies and the recognition of microfinance as a mainstream development sector.

GEMA PKM aims to reduce poverty and socioeconomic inequality by empowering the people's economy. Its objectives are to increase the number and quality of MFIs; increase the number and quality of support institutions for self-help groups; develop linkages between MFIs and support institutions; increase the participation of individuals, groups, and financial institutions in developing microfinance; and increase access by the poor to financial services and technical business support services.

Bankers associations, such as the *Perbarindo* network of BPRs, have been providing training on microfinance for years and are now developing capacity-building tools in coordination with GTZ and BI in order to strengthen BPR performance and increase access to market sources of funds. Five training modules are under development for account officers, internal auditors, bank office, management, and accounting, respectively. Those trained will hold a certificate and BPRs having completed the training will be recommended to access market sources of funds upon examination of their financial status by BI's BPR Supervision Department.

Perbarindo has a three-tier structure consisting of a central board (*Dewan Pimpinan Pusat*, or DPP), and 17 regional offices (*Dewan Pimpinan Daerah*, or DPD) located at the provincial level throughout the country (including Java, Bali, West Nusa Tenggara, East Nusa Tenggara, and some provinces in Sumatra, Sulawesi, Kalimantan, Irian, and Maluku), although 82% of the members are located on Java and Bali.[110] The total number of BPRs as of March 2002 was 2,216, but only two thirds were *Perbarindo* members (membership is optional). Sharia BPRs have their own sister network called ASBISINDO.

The mission of BK3I as the national apex organization for the cooperative movement and its regional chapters is to strengthen the

development of autonomous and self-reliant cooperatives. Training, insurance, interlending, and supervision are the major tasks carried out by the secondary structures of the movement (i.e., 16 of the 28 regional chapters established by BK3I that have adopted the status of secondary cooperatives). As of end-1999, 89% of the cooperatives were participating in the movement's interlending system and 57% of them were participating in its credit insurance program. Cooperatives receive training through their BK3I regional chapter with courses for beginners, advanced staff, and managers. The credit unions have to pay part of the training costs, while another part is subsidized from income of the secondary cooperatives and from donations.[111]