

4 Implications of Microfinance Commercialization

The long history of microfinance in Indonesia provides some evidence regarding the implications of commercialization. The formality and savings focus of leading MFIs have definitely contributed to large-scale, sustainable access to demand-driven microfinance. However, while commercial MFIs have had a good record of reaching the poor in many areas, their outreach is still uneven in areas below the subdistrict level and in locations with relatively low population density. Contrary to a common assumption, commercialization has not led to significant mission drift—real interest rates and average outstanding loan amounts have generally remained stable over the last 10 years. Nonetheless, it can be argued that the full benefits of commercialization have not yet been realized, mainly because of state ownership of Indonesia's largest MFI, the BRI Units, and the resulting lack of competition caused by its monopoly power in many rural areas.

COMMERCIALIZATION HAS ALLOWED LARGE-SCALE, SUSTAINABLE OUTREACH

Support for commercialization of microfinance is primarily based on the assumption that commercialization assists large-scale expansion of sustainable microfinance, and the Indonesian case provides positive evidence for this assumption. In Indonesia, savings mobilization by predominantly formal MFIs has fueled broad microcredit outreach. Even more remarkable, however, is that commercialization has allowed the sustainable expansion of microsavings services on an unprecedented scale.

Unsurpassed microcredit outreach has been fueled by savings mobilization. Indonesia's microfinance industry has, by a wide margin, the

largest breadth of outreach in the world in terms of the numbers of clients reached. More than 80% of all microloans in the country are lent on a profitable basis through formal institutions, such as the BRI Units, BPRs, and PP. With the exception of the pawning company, deposit mobilization has played a major role in making possible the provision of sustainable microcredit services by these and other MFIs. The availability of deposits to fund loan portfolios has reduced the need for and prevalence of borrowing by MFIs from commercial banks.

Development of demand-driven savings services has provided a large and stable source of commercial funds for formal MFIs. Voluntary savings constitute the bulk of loanable funds for the BRI Units and BDB (Box 4.1). At the end of 2001, the value of savings in the BRI Units exceeded the amount of loans outstanding by 1.61 times (and their total deposit to [outstanding] loan ratio was 2.24). Estimates for the total BPR system

Box 4.1

Bank Dagang Bali's Performance in Mobilizing Voluntary Savings

Since BDB's inception in 1970, the value of savings it has mobilized has exceeded the average amount of its outstanding loans. In 1996, for example, "BDB had \$113 million in savings and \$94 million in outstanding loans. That same year though, there were 23 times as many savings accounts (363,859) as loans (15,645), reflecting both state-of-the-art local savings mobilization methods and a relatively conservative loan policy."

Source: Adapted from Robinson 2002, p. 144–154.

as of July 2002¹¹² suggest that the value of total deposits is 90% of the amount of outstanding loans, indicating that they too fund their loan portfolios primarily with deposits. Deposits form the majority of loan capital even in semiformal MFIs, such as the LPDs and credit unions.

The prevalence of commercial MFIs has also contributed to changing perceptions held by many practitioners regarding savings as a means to serve poor and vulnerable clients. Indonesia's microfinance industry is also the world's leader in terms of providing access to safe and reliable savings services. As of end-2001, the BRI Units had 27.0 million deposit account holders (Rp22.0 trillion, or \$2.1 billion), 24.2 million of them in the *Simpedes* savings product alone (Rp15.9 trillion, or \$1.5 billion).

The experience of commercial MFIs, and particularly the BRI Units, has shown that satisfying client demand for safe and liquid savings instruments is just as, if not more, important than satisfying their demand for credit.¹¹³ While not all microfinance clients need to borrow at all times, most maintain savings or other types of deposit accounts. Another motivation for mobilizing savings by commercial MFIs has been their recognition that savings facilities provide a valuable service for clients who might need it most (in terms of liquidity and expenditure management), and especially poorer clients who want to build their debt capacity for future loans. These attributes are taken into consideration when designing demand-driven deposit services and for gauging client creditworthiness.

Microfinance commercialization has resulted in a wide scope of outreach in terms of the numbers and types of financial contracts supplied.¹¹⁴ Access to microcredit from the BRI Units and BPRs is flexible with terms and repayment schedules generally tailored to the cash flows of the clients' activities. Numerous types of deposit services are also available at the BRI Units and BPRs with different mixes of liquidity and returns. The BRI Units also offer other financial services, such as money transfers and serving as payment points for telephone, electricity, and property tax bills. The wide range

of microfinance products and services available was the result of a commercial approach, which in turn improved the quality of outreach. The goal of the commercial MFIs is to offer all of these products and services on a fee basis, setting the interest rates and any other applicable charges high enough to cover the costs of the transaction. And microfinance clients can pawn numerous types of goods and produce at PP, among other pawn service providers.

Commercial MFIs have a good record in reaching the poor, although as mentioned, outreach is uneven in less populated, rural areas. Contrary to a common assumption held by skeptics of commercialization, commercial microfinance in Indonesia has achieved significant depth of outreach in that it has a good record in reaching poor clients. The most common proxy for depth of outreach is loan size. Although the average microcredit loan amount varies widely, revealing broad market coverage, depth of outreach of major commercial suppliers of microcredit in Indonesia is greater than the average for MFIs worldwide and approximately double the average in MFIs that have achieved financial self-sufficiency (Table 4.1).¹¹⁵

The BRI Units and even some of the BPRs have had success in pioneering and expanding village units and mobile services in poor rural areas. While the requirements for collateral and/or cosigners on most loans provided by commercial MFIs, such as PP, the BRI Units, and the BPRs, may exclude the poorest borrowers, it does not appear to have diminished their outreach to the poor. Even the average outstanding loan size of the BRI Units, which is the highest among major commercial MFIs, is only half the GDP per capita and low compared to MFIs worldwide.

However, villages and less populated areas remain the domain of tiny traditional financial institutions that are unable to benefit from economies of scale and suffer from lack of legal status and human capacity to undertake financial intermediation. In addition, although demand may be largely depressed among small farmers and agriculturally-based microenterprises (due to low or negative returns of most types of

Table 4.1: Major Suppliers of Microcredit, 2001

	Average Outstanding Loan (\$ Equivalent)	% of GDP per Capita
BRI Units	337	49.9
BPRs	333	49.0
<i>Perum Pegadaian</i>	42	0.1
MBB Average, MFIs Worldwide	453	66.6
MBB Average, FSS MFIs Worldwide	752	110.6

Notes: BRI = *Bank Rakyat Indonesia*; FSS = financially self-sufficient; MFI = microfinance institution; MBB = MicroBanking Bulletin.

“MBB Average, MFIs Worldwide” includes data on 147 MFIs that submit data to MBB for adjustment and comparison purposes.

“MBB Average, FSS MFIs Worldwide” captures data on 62 MFIs that MBB classified as financially self-sufficient.

Source: Authors’ calculations and MBB 2002.

agricultural production), this potential market niche has remained virtually ignored in terms of microcredit and more importantly, microsavings.

The outreach of commercial MFIs has proven to be sustainable as demonstrated during the recent Asian financial crisis. With the sharp downturn in financial intermediation by traditional commercial banks, PP saw its pawning operations almost double during the time of the crisis (1997–1999) and since then, PP’s business has continued to grow. Like the commercially-run operations of PP, the microbanking systems of BDB, the BRI Units, and many of the BPRs were professional and fundamentally sound, flexible enough to respond to changing demand during the crisis, and robust enough to weather it. By virtue of their formal status and professionally-run microfinance operations, these MFIs had built up sufficient trust for their depositors to believe that their savings would be secure; the formal MFIs were even able to attract savings transferred to them from failing traditional commercial banks.

A major factor leading to success of commercial MFIs during the financial crisis was

substantial liquidity that they maintained so that capital was not constrained. When borrowers perceived the availability of future loans, they “wanted to retain their option to re-borrow and made loan repayment a high priority.”¹¹⁶ Further, “the crisis convincingly provides that savings deposits at BPRs are...even in difficult times the most stable source of funding.... The most dynamic and best-managed BPR were always those with a strong savings base.”¹¹⁷

COMMERCIALIZATION HAS NOT LED TO SIGNIFICANT MISSION DRIFT

Contrary to the common assumption that private ownership (by profit maximizing investors) will shift an MFI’s target market from the poor to the less poor and nonpoor (mission drift), this has not occurred to any extent in Indonesia. Indicators of mission drift include increasing average outstanding loan amounts, increasing effective interest rates charged on microloans, lower proportion of low-income female clients, and more higher-income male customers. Few, if any, Indonesian MFIs have indicated such changes. Details concerning these three indicators follow.

Steady Average Outstanding Loan Amounts

When compared to changes over time in GDP per capita, there is stability in the average loans lent by the BRI Units. Average outstanding loan amounts and the effective annual interest rates charged on microloans have been much more affected by inflation than change in target clientele. For example, although in nominal terms the average outstanding *Kupedes* loan size increased by nearly 350% from 1991 to 2001, the total change over the period was only 26% in real terms, or about a 3% real increase per year (Table 4.2). The BRI Units’ average *Kupedes* loan size has stayed relatively constant at 40–60% of GDP per capita over the last 10 years or more, despite the business growth and increased debt capacity that many of their microborrowers have enjoyed over time.

Table 4.2: BRI Unit *Kupedes* Loan Sizes Compared to GDP per Capita

Year	CPI	GDP per Capita (Rp)	Change (%)	Avg. O/S Kupedes Loan (Rp)	Change (%)	Loan Size/ GDP per Capita	Avg. O/S Kupedes Loan at 1995 Prices (Rp)	Change (%)
1990	65.25	1,174,872		729,913		0.62	1,118,641	
1991	71.39	1,378,075	17.3	792,204	8.5	0.57	1,109,685	-0.8
1992	76.77	1,530,679	11.1	899,986	13.6	0.59	1,172,315	5.6
1993	84.21	1,757,962	14.8	1,032,395	14.7	0.59	1,225,977	4.6
1994	91.38	2,004,510	14.0	1,196,800	15.9	0.60	1,309,696	6.8
1995	100.00	2,333,833	16.4	1,409,702	17.8	0.60	1,409,702	7.6
1996	107.97	2,706,001	15.9	1,638,251	16.2	0.61	1,517,320	7.6
1997	115.24	3,140,516	16.1	1,791,257	9.3	0.57	1,554,371	2.4
1998	181.66	4,675,438	48.9	1,911,079	6.7	0.41	1,052,009	-32.3
1999	218.89	5,350,848	14.4	2,407,725	26.0	0.45	1,099,970	4.6
2000	227.03	6,131,788	14.6	2,935,787	21.9	0.48	1,293,127	17.6
2001	253.14	6,939,909	13.2	3,538,500	20.5	0.51	1,397,843	8.1

CPI = consumer price index; GDP = gross domestic product; O/S = outstanding.

Source: BRI Micro Business Division.

In addition, given the BPR experience, increased local private ownership has broadened microfinance service provision to a wide range of clients at the village level (for institutional risk management and continued good community standing) and mission drift has generally not been a factor. There have been a few instances in which cooperatives were formed to act as quasi-banks/moneylenders to take advantage of relatively lax cooperative regulation and supervision to lend small amounts at very high interest rates, but these instances have been exceptions and not the norm.

Stable Real Interest Rates Charged on Loans

The BRI Units had a real average annual yield earned on their loan portfolio of 21.7% in 1985. It was maintained at 22.4% in 1990, 20.2% in 1995, and it remained stable during the Asian financial crisis.¹¹⁸ Such pricing by the microfinance market leader has led to similar flat yield changes by private microfinance providers. Most MFIs in Indonesia, being commercial institutions, have always been concerned with institutional viability. As such, most MFIs have

not had to experience a major shift from social to commercial orientation, even though their performance has varied widely. NGOs, such as *Bina Swadaya*, have established local, privately owned BPRs, but they have maintained their focus on increasing access by the poor to sustainable microfinance (see Box. 2.4).

No Discernable Shift in Target Market with Respect to Gender

Although women are considered to be an important market for microfinance, targeting of women exclusively has never been a hallmark of the Indonesian microfinance industry. One could argue that this is a result of commercialization and the lack of socially-oriented microfinance programs to target female borrowers, who tend to request smaller loans. However, the average proportion of female clients served by major MFIs overall has remained fairly constant over the last 20 years, indicating that MFIs' missions have not drifted with respect to gender. For example, estimates for the BRI Units indicate that around 25% of both their microcredit borrowers

and microsavings customers have been women and this percentage has remained stable. BDB estimates that the proportion of its women microsavers and microborrowers has fluctuated from 11% to 25% over the last several years, with no discernable trend, except that at any given time about 90% of its clients are repeat customers.

**COMMERCIALIZATION HAS NOT YET
YIELDED COMPETITION**

There has been a lack of competitive pressure to ensure broad market efficiencies. Where commercialization has taken the greatest hold, competition has indeed been stronger and efficiency gains have been realized (e.g., with formal institutions, such as the BRI Units and BPRs that operate predominantly at the district and subdistrict levels, especially around more populated regional capitals). However, competition is not yet a factor below the subdistrict capital level and the BRI Units enjoy near monopoly power to maintain lending interest rates substantially above cost. Lack of competitive pressures in many rural areas may have resulted in market inefficiencies with negative consequences for customers and other market participants.¹¹⁹

BRI's status as a state-owned bank has made deposit mobilization and liquidity management by other MFIs more costly and difficult than if a level playing field existed. In terms of rural deposits, BRI is clearly the market leader, accounting for almost 80% of the accounts and 86% of the deposit volume (see Table 2.2). The monopoly position of the BRI Units in many locations has allowed it to act as a market/price maker—pushing up the interest rates having to be paid on deposits by other formal MFIs. Despite the common assumption that increased commercialization will lead to increased customer focus and more demand-driven products and services, this process in Indonesia has been hampered by the dominance of BRI.

BPRs and other small financial institutions have found it hard to compete with government-owned BRI Units in deposit mobilization and the implicit government-guaranteed safety of deposits; “hence, BPRs are forced to offer higher returns on deposits and better service, e.g., doorstep collection of savings, in order to attract depositors. Furthermore, most BPRs are independent unit banks with no access to a liquidity like BRI, exposing them to much higher risks and costs. This situation has placed the BPRs at a comparative disadvantage vis-à-vis the BRI Units.”¹²⁰

5 Microfinance Commercialization Challenges

Over the last 20 years, the growth of commercial MFIs in Indonesia has led to significant breadth, depth, scope, and sustainability of outreach. The greatest challenge presently facing the Indonesian microfinance industry is to expand access by the poor and near poor to microfinance at the village level and in more remote, less densely populated areas. However, several challenges to expanding access to commercial microfinance exist at the macro (operational environment) and micro (institutional) levels. Below are a few of the most pressing challenges to the expansion of commercial microfinance in Indonesia.

CONSTRAINTS IN THE OPERATING ENVIRONMENT

Constraints in the operating environment include inappropriate government interventions in terms of subsidized, directed credit programs, weaknesses in the legal and regulatory framework concerning BPRs and a variety of NBFIs, and absence of a few key microfinance industry support institutions.

Subsidized, Directed Microcredit Programs

Ongoing government-subsidized, directed microcredit programs and the threat of additional cheap credit inhibit private sector initiatives to provide microfinance on a commercial basis. A recent ADB report¹²¹ on the microfinance sector found that there are 70 programs and projects for poverty reduction under various ministries and other national government institutions and that many of these have a microfinance component. These programs have large funding allocations—a combined budget allocation in FY2002 alone amounting to Rp16.5 trillion (\$1.8 billion).

Two prominent examples of these programs at the national level include the Family Welfare Income Generation Project (*Usaha Penengkatan Pendapatan Keluarga Sejahtera*, or UPPKS) implemented from 1996 to the present by the National Family Planning Coordination Board and the UED-SP (*Unit Ekonomi Desa-Simpan Pinjam*, or Village Economic Units – Savings and Credit) promoted by the Ministry of Home Affairs and Regional Autonomy since 1995. The former includes the extension of microcredit to eligible women's groups at a highly subsidized, effective annual interest rate of 6%. The latter allocated in recent years substantial subsidies to village governments for establishment of small-scale financial institutions modeled after the BKDs. These have acted more as disbursement centers for government-subsidized directed credit than the intended village banks having true member ownership. The huge amount of funds channeled for poverty reduction and in reaction to the Asian financial crisis through programs such as these have diminished the repayment culture and become a constraint to growth of commercial MFIs.¹²²

In addition, following government decentralization in 1999, various district governments have also become interested in microcredit provision. Enjoying their new budget distributions, many district governments have started poverty reduction programs with microcredit or microfinance components in recent years. Like many of the poverty reduction programs sponsored by the national Government, these new district-level institutions and the amount of grant or cheap funds channeled through them (funded in large part by the BMM program) have inhibited private sector institutions and operations (Box 5.1). This trend is likely to increase in the future. A total of Rp2.2 trillion (\$244 million) was channeled through the