

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

Box 5.1

District Government Emphasis on Creating New MFIs without Clear Strategies for Sustainability

The Regent (*Bupati*) of Lombok Timur district issued a decree in February 2001, which called for the establishment of MFIs (LKMs), and has provided a grant of Rp1.5 billion for channeling to selected new MFIs. So far, Rp450 million has been disbursed to 15 MFIs with a target of 40 MFIs to be established by the end of 2002. Another example is the West Lampung district on the southern tip of Sumatra. The Regent issued a decree to create a so-called “MFI management team” consisting of representatives from various government line agencies. The team is responsible for promoting and monitoring MFIs. The district administration has allocated a budget of Rp210 million for MFI support but the bulk of the funds for MFIs comes from the Direct Grant Support Program (*Bantuan Langsung Masyarakat, BLM*) which is funded from the BMM program geared to compensate for reduced oil and gas subsidies.

Source: Adapted from ADB 2002a, p. 4–5.

BBM program in 2002 and this amount will double to more than Rp4 trillion in 2003 as compensation for the recent energy price increases.

Of the 70 national government-sponsored poverty reduction programs, at least 16 were identified to address poverty issues under a long-term strategy of the Government, mostly supported by donors.¹²³ These programs have a total budget of almost Rp3 trillion (\$332 million) (Table 5.1).

Most of these 16 programs also include a microcredit or microfinance component. The most common interventions are grants, revolving funds, heavily subsidized credit, and semicommercial credit. Although well intended, many of these programs do not follow established microfinance best practices and have undermined rather than supported sustainable microfinance

development. Specifically, they mix grants and credit, they do not clearly separate financial and social intermediation, and they frequently apply subsidized interest rates.

Deposits Mobilized by NBFIs at Risk

Institutional proliferation—more than 4,500 BKDs, around 1,600 LDKPs, more than 40,000 microfinance cooperatives, in excess of 1,000 credit unions, and around 400 microcredit NGOs—has led to market segmentation and a multitude of relatively weak MFIs at the village level. In some cases, the legal framework is unclear; in others, it is simply inappropriate or absent. Limited savings mobilization has been tolerated, but because there is little or no enforced supervision and reporting requirements of most of these NBFIs, these small savings are at risk of loss. This issue is especially important because the best estimates indicate that these NBFIs have collectively mobilized more than Rp1,871 billion in deposits in recent years (see Table 2.2 for details). If a significant amount of client savings were lost, it would be very difficult for microfinance institutions to continue to attract savings, which are an important commercial source of funds, at a reasonable interest rate.

Weaknesses in BPR Regulation and Supervision

The BPR regulatory regime has been based on that of commercial banks, which is a regime that is not appropriate to the specialized operations of these microbanks. In some areas, the regulations are overly strict and in other areas the existing regulations are too lax, especially in terms of loan classification, provisioning, and write-offs. One of the most obvious constraints facing the BPRs in their expansion of commercial microfinance is the high minimum capitalization requirement stipulated by recent BPR regulations. BI Decree No. 32 (Sections 35 and 36), enacted in May 1999, increased the minimum capital requirement to establish a BPR from Rp50 million to Rp2 billion (equal to \$192,308 at end-2001) for the national capital

Table 5.1: Budget Allocations of Major Poverty Reduction Programs, 2002

Ministry/Institution	Program	Budget (Rp million)	Budget (\$million)
National Family Planning Coordination Board	1. Family Welfare Income Generation Project (<i>Usaha Penengkatan Pendapatan Keluarga Sejahtera, UPPKS</i>)	1,370,833	153.3
Ministry of Agriculture	2. Rural Income Generation Project (RIGP) (<i>Proyek Peningkatan Pendapatan Petani – Nelayan Kecil</i>)	19,855	2.2
Ministry of Settlement and Regional Infrastructure Development	3. Urban Poverty Alleviation Project (<i>Program Penanggulangan Kemiskinan di Perkotaan, P2KP</i>)	438,910	49.1
Ministry of Industry and Trade	4. Partnership Program (<i>Program Kemitraan</i>) 5. Establishment of New Entrepreneurship 6. Business Clinic Development	3,483	0.4
Ministry of Cooperatives and Small and Medium Enterprises	7. Revolving Fund Provision for Savings and Credit Unit (USP)/Savings and Credit Groups (KSP)/Microfinance Institutions (LKM) Program 8. Capital and Financial Institution Strengthening through Provision of Initial Capital and Funding (P3LKMAP)	90,000	10.1
Ministry of Marine and Fishery	9. Empowerment of Coastal and Small Islands Population 10. Management and Exploitation of Small Islands	8,225	1.0
Ministry of Home Affairs and Regional Autonomy	11. Kecamatan Development Project or <i>Proyek Pembangunan Kecamatan</i> (PPK) 12. Regional Empowerment Project (<i>Proyek Pemberdayaan Daerah</i> , PPD)	1,028,000	115.0
Ministry of Women Empowerment	13. Women Empowerment through Local Economic Development (<i>Pemberdayaan Perempuan melalui Pengembangan Ekonomi Lokal</i> , P3EL)	4,000	0.5
Central Bureau of Statistics	14. Evaluation of Poverty Indicator Methodology 15. Regional Calculation of Poor Population in Social Economic Survey 2002	206	0.02
National Land Use Agency	16. Land Use Management (land redistribution) for Sharecroppers	944	0.1
Total		2,964,456	332.0

Source: Adapted from ADB 2003, p. 5–6.

area,¹²⁴ to Rp1 billion (\$96,154) for provincial capitals, and Rp500 million (\$48,077) for other areas. With a minimum paid-up capital 10 times as high as the previous requirement, new BPR establishment in rural areas is practically impossible.

These high entry barriers contradict the idea of the banking reforms of the late 1980s and early 1990s, which were geared toward the expansion of banking in rural areas. The intention of the 1999 regulatory changes was to develop a sound industry with fewer but larger BPRs. In fact, only 13 new BPR licenses were issued in the first 3 years after capital requirements were substantially increased. This requirement changes the BPR character from a local secondary bank to a small primary bank, but it does not necessarily improve the soundness of the industry.¹²⁵

Political Economy of Cooperatives

Provisions in the Cooperative Law legalize direct government intervention into the cooperative sector and even require the Government to provide protection and preferential treatment. Use of the provisions to channel funds to targeted beneficiaries has corrupted the integrity of cooperatives as viable institutions. As long as this practice continues, it will be difficult to proceed with institutional capacity building. In principle, the cooperative organization of microfinance, especially at the village level, has great potential in Indonesia. However, using this potential amid the poor state and reputation of the cooperative sector is foremost a political issue. It requires a new political consensus about the role of the State in cooperative development, a role that should change from direct intervention to provision of an enabling environment.¹²⁶

Gaps and Deficiencies in Cooperative Law¹²⁷

There exists a basically sound regulatory framework for KSPs and USPs that are separated from other business units of primary or secondary cooperatives. Provisions for financial soundness and supervision exist and can support the

development of cooperatives. However, a few critical issues remain with regard to both specific attributes of the regulations themselves and their enforcement.

The prudential framework for cooperatives has a few serious inadequacies and generally lacks adequate sanctions and penalties for noncompliance. For example, the loan classification system is lax and there are no requirements for loan loss provisioning. Capital is not properly defined and there are no sanctions for a capital ratio of less than 20%. Moreover, the CAMEL rating system in use should be simplified and there should be sanctions for low ratings. The regulations also include provisions that tend to force small and informal groups with savings and credit activities into the semiformal cooperative sector.

In addition, the supervisory regime for cooperatives is unclear—one regulation refers to “guidance,” another to “supervision,” and still another to “controlling measures.” There is also no capacity in the Ministry of Cooperatives to supervise or even to guide KSPs/USPs. In addition, deposit protection only applies to banks: the approximately \$200 million of deposits in urban cooperatives (USPs) and KSPs are at risk without any enforced system of regulation, supervision, or deposit protection.

The Ministry of Cooperatives is also concerned that large numbers of mainly urban-based KSPs/USPs are dealing with persons who have no intention of becoming members. The ministry is presently reviewing the Cooperative Law and its regulations. One option being considered is to allow deposits from the public, but to require loans to be made only to members. The ministry is aware of the deficiencies of the present system, but is constrained by a lack of resources and the fact that it has largely lost control of supervision, guidance, and enforcement; these functions have been decentralized to the provincial and district governments.

Lack of a Deposit Insurance Institution

The policy to provide a blanket deposit guarantee during the height of the financial crisis

to regain public confidence in the banking sector proved effective in 1998. Within a short time, deposits flowed back into the banking system and currently public savings have reached approximately 70% of total bank assets.¹²⁸

However, behind this success is the large burden that has to be borne by the Government and the potential moral hazard in the banking sector. A more effective and sustainable guarantee of savings is required.

No Credit Information Bureau

Exchange of information between the BPRs, BRI Units, and BI is common, although on an ad hoc basis. Typically, the BPRs ask BRI or other BPRs whether or not the credit applicant is indebted to other banks. Law No. 10 of 1998 stipulates that BI shall facilitate such exchange of information. In an attempt to implement its task more effectively and efficiently, Bank Indonesia conducted on 31 March 2000 a reorganization at the Directorate of Credit, which formerly comprised five divisions, into a Credit Administration and Management Division. The latter included a development team to create a credit information system. BI saw the need for a policy on technical support for credit extension to micro and small-scale businesses. The goal of its Credit Information System Enhancement Project is to develop the highest quality of information possible, and is looking to learn from credit bureau development in other countries, such as Thailand and Australia.

Absence of Local Microfinance Training Institution

There is a lack of local training institutions, for both MFI managers and line staff, to promote management and retailing capabilities in line with local and international best practices in microfinance. Although BRI conducts some training courses and BPR-specific training is provided by *Perbarindo*, there is no “one-stop shop” that can provide quality, demand-driven and cost-effective training in microfinance.

INTERNAL CONSTRAINTS

BRI Units

The achievements of the BRI Units in terms of financial self-sufficiency and outreach have been unparalleled elsewhere in the world, but there are a few important shortcomings of the system and areas of untapped potential. Despite the high profitability of the BRI Units, their status as a profit center within a state-owned bank puts the system’s financial self-sufficiency at some risk. This was made clear during the recent Asian financial crisis, when the Units’ profits were used to stabilize the failing corporate loan division. Use of Unit profits to cover losses made in other departments at BRI engaging in larger-scale lending has inhibited the expansion of rural microcredit in terms of depth of outreach and provision of more flexible and demand-driven products to low-income households at the village level.

Significant Risk in the BRI Unit System

Significant risk continues to be associated with the BRI Unit system serving as a profit center within an otherwise loss-making state-owned bank. The experience of BRI and its Units during the 1997–1998 Asian financial crisis makes plain the negative attributes of the Unit system being housed within a state-owned bank. Although it is a fact obscured by consolidated financial figures, the BRI Unit system has generated enough profits to sustain the rest of BRI since the early 1990s. It was solely due to the Units’ performance that, on a consolidated basis, BRI posted a positive net income except during 1998/99 (Table 5.2).

In 1998, when BRI was hit by the financial crisis, 56% of the branches’ loan portfolio, mostly large corporate loans, “turned sour and had to be written off.”¹²⁹ By December 1998, the bank had loan loss provisions (Rp22.1 trillion, or \$2.2 billion) equal to almost half of its loan portfolio, reducing its assets to Rp34 trillion (\$3.3 billion). Losses increased to Rp26.4 trillion (\$2.6 billion)

Table 5.2: Profitability of the BRI Unit System Versus the BRI Branch Network

	(Net income in \$ million)							
	1993	1994	1995	1996	1997	1998	1999	2000
BRI (consolidated before tax)	57	67	111	145	30	-3,308	-243	
of which								
a. Branch network	-10	-54	-64	-33	-60	-3,397	-411	
b. Unit banking system	66	121	174	178	90	89	168	121

Blank entries mean no data are available.

Source: Maurer and Seibel 2001, p. 14.

destabilizing the bank. In 1998, BRI entered the restructuring and recapitalization program, with the Government's recapitalization bonds of Rp20.4 trillion (\$2.0 billion) and bad debts transferred to IBRA.¹³⁰

As of November 2000, Rp17.6 trillion (\$2.1 billion) of BRI's bad debts transferred to IBRA were outstanding to only 168 borrowers.¹³¹ This amount was equivalent to an estimated 40% of the bank's loan portfolio at the time these debts were transferred to IBRA. Although BRI remained a major source of rural credit, the corporate arm, with its huge losses, considerably inhibited the expansion of rural credit, particularly because profits made by the BRI Units may have been used to compensate for the losses incurred by other BRI activities. "The vast profits of the Unit system have been used to cross-subsidize wealthier (non-low income) clients of BRI."¹³² The Units' impact on rural development and poverty reduction could have been much greater, if the "large surplus had been used to decrease the spread between its on-lending and deposit interest rates."¹³³

The BRI Units continue to cross-subsidize BRI for its less efficient lending to larger clients. The cross-subsidization needs to be abolished on both equity and efficiency grounds. The equity argument states that greater breadth and depth of market coverage can be attained by lending at unsubsidized interest rates. Efficiency concerns are that funds can be allocated to the most productive uses when the risk-adjusted lending interest rate reflects the economic opportunity cost of funds.¹³⁴

Overly Conservative Lending policies

Overly conservative lending policies of the BRI Units, despite their extremely liquid position, have unnecessarily limited their client base. The BRI Units are clearly the backbone of the rural microfinance system in Indonesia. One of the main challenges for the future development of the BRI Unit system is to increase its breadth (in terms of geographic and sectoral coverage) and depth of outreach (with regard to reaching low-income households at the village level), while maintaining its high degree of financial self-sufficiency.¹³⁵

BRI so far has reached the smaller, mostly urban part of the potential market in all sectors of the economy. Its borrowers number 2.8 million out of a population of more than 200 million, the majority of whom live and work in rural areas. The distribution of *Kupedes* loans outstanding by economic sector shows a clear concentration in small trade (42%) and for fixed salary employees (30%). Only 22% of the loans were provided for agriculture and just 2% for small industry (Table 5.3).¹³⁶

Microcredit expansion has been limited. Most of the units are located in subdistrict capitals or in the vicinity of urban areas where the important clientele of government employees and traders with sufficient collateral and fixed income is concentrated. The Units' risk-averse lending policy has largely prevented their outreach to potential customers without a fixed income or collateral, such as land and motor vehicles.¹³⁷

Table 5.3: Distribution of *Kupedes* Loans by Economic Sector, as of December 2000

Economic Sector	Number of Loans Outstanding	Share (%)	Loan Amount (\$ million)	Share (%)
Agriculture	589,834	21.7	177.0	21.7
Industry	66,329	2.4	19.2	2.4
Trade	1,154,838	42.5	338.6	41.5
Fixed Salary Employees	817,041	30.2	242.9	29.7
Others	87,566	3.2	38.1	4.7
Total	2,715,608	100.0	815.8	100.0

Source: BRI Microbanking Division, as cited in Maurer and Seibel 2001, p. 13.

The financial drain occurring within BRI remains a critical issue. Throughout the 1990s, more than half of the savings mobilized by the units were deposited in the branches.¹³⁸ The current deposit-to-outstanding-loan-portfolio ratio of over 223% points to the incredible success in savings mobilization and, at the same time, to the restrictive lending policy of the Units. Both the high profitability of the Units and their inefficiency in transforming deposits into loans indicate the vast potential to increase the system's lending to small business and low-income households with more relaxed or flexible credit rules, and without placing the system's profitability at risk.¹³⁹

BPRs

Limitations Stemming from the Unit Bank Structure

BPR outreach is concentrated in urban areas of Java and Bali provinces (comprising some 82% of the total number of BPRs).¹⁴⁰ Outreach into outlying provinces and their rural areas is very limited. The main constraint for expanding the BPR industry relates to the high minimum capitalization requirements discussed above that limit BPR branching ability. Lack of a national branch network also poses a constraint to BPR expansion in terms of being able to distribute credit risk geographically, to manage bank liquidity needs, and to provide customers with

possibilities to withdraw savings or otherwise access their accounts in other areas.

The BPR system as a whole has substantial liquidity. However, much of it is needed to offset the high ratio of term deposits to savings deposits to provide a cushion for increased lending and to offset the lack of an effective inter-BPR liquidity transfer mechanism. Access to support services is also a challenge because of the unit-based structure of BPRs. The development of new microfinance products and services, training of staff, and enforcement of effective auditing and control mechanisms are expensive—the costs are too great for a single BPR.

Weaknesses in Ownership, Governance, and Banking Skills

Weaknesses in ownership, governance, and banking skills constrain BPR productivity. Poor governance is an issue that faces mainly the 25% of the BPRs owned by provincial governments, because these units tend to be managed according to bureaucratic command rather than market orientation; their operations are less efficient than those of privately-owned BPRs.

General BPR deficiencies occur in professional banking knowledge, planning, product development, marketing, and staff productivity; these result in low growth, limited outreach, and barely viable institutions. Staff productivity is less than half that of the BRI Units. Frequently, staff are selected on the basis of family

relationships rather than on ability, and career prospects for young staff are limited. Administration expenses on loans outstanding are frequently 22–30%. In many, staff are too familiar with their customers and too lenient in the enforcement of contractual obligations, leading to poor recovery of full interest payments on loans outstanding.

LDKPs

Weak Ownership and Governance

Ownership by the *Desa Adat* makes KDKPs susceptible to communal conflicts that affect management and operations. Some *Desa Adat* lack written customary laws required for making enforcement effective. Weak enforcement ability in some cases has undermined good performance. The enforcement capacity of *Desa Adat* is especially limited in cases where LPDs provide financial services beyond its boundaries.

Structural Weakness of the Support System

Structural weakness of the support system available to LPDs in need of technical assistance affects potential growth opportunities. The regional development banks (BPDs) cannot provide the required number of trainers and consultants, and the PLPDK (*Pusat LPD Kecamatan*, or subdistrict LPD centers) staff are often not capable of providing the assistance required. Training provided to LPDs is seldom based on an adequate assessment of training needs and training impact. It does not appear to have a significant positive impact on performance. The transformation of individual learning into institutional practice requires a comprehensive training and consultancy system that is able to respond to the specific problems and needs of individual LPDs.

Lack of Appropriate Regulation and Supervision

The former requirement to convert LDKPs to BPRs did not reflect the needs of institutions like the LPDs. This fact led BI to allow LPDs to operate temporarily as nonbanks. In addition, the supervision of LDKPs lacks a clear distinction from technical assistance functions and involves too many parties to be effective. The system also lacks the capacity to carry out on-site supervision adequately and has not been enforcing compliance with existing regulations.¹⁴¹

BKDs

Weak Ownership and Governance

Ownership and the legal form of BKDs are vague; management and control functions are not clearly separated, so they lack effective internal control and supervision by owners. These factors have apparently also contributed to the lack of sense of ownership and trust among the village population. Externally, BKDs have been tolerated as a historical legacy, while significant efforts to transform them into independent and viable institutions have not been made.

Lack of Dynamism

Although the BKD industry has comparative advantages in operating on a part-time basis within a limited and familiar environment, it is held back as a whole by a lack of dynamism. Its organization, operations, and products have hardly changed despite decades of changing demand for financial services. Efforts of BRI in the early 1990s to instill a new culture by introducing voluntary savings products failed. Open either twice a week, twice a month, or in a few cases, only once a month, BKDs generally limit their operations to extending credit to a small number of regular customers and have not actively tried to expand their customer base. BKDs lack strong market orientation, skilled human resources,¹⁴² and the systems required for small banks.