6 Positive Approaches to Microfinance Commercialization

Much of Indonesia's microfinance industry operates on what can be considered very commercial terms. Nevertheless, there are many providers, such as the multitude of nonbank MFIs, that do not yet operate on a commercial basis. In addition, the financial and outreach performance of many commercial MFIs has been highly differentiated. There still exists an "unbanked majority" of microentrepreneurs and poor households without access to sustainable microfinance through appropriately regulated and supervised institutions. Several key stakeholders, including the Government, donors, MFIs, and support institutions have roles to play in advancing microfinance commercialization and ensuring that its full benefits are realized. The top 10 priorities, highlighted in Table 6.1, and other recommendations are discussed.

Table 6.1: Top 10 Priorities for Moving Microfinance Commercialization Forward

1	Stop the provision of subsidized, directed microcredit
2	Strengthen BPR regulation and supervision
3	Formulate activity-based regulation and supervision adapted for the specialized operations of banks engaging in microfinance
4	Improve the legal and regulatory framework for cooperatives
5	Assess the feasibility of establishing an apex bank for BPRs
6	Facilitate the provision of deposit insurance
7	Improve BPR institutional capacity
8	Assess the potential for privatizing the BRI Units and *Perum Pegadaian*
9	Promote the establishment of a local, commercially-oriented microfinance training center
10	Invest in social intermediation and infrastructure development, especially in rural areas

ROLES OF THE GOVERNMENT

The main role the Government should play in commercialization of microfinance is to create and maintain an enabling macroeconomic and sectoral policy environment and an appropriate legal and regulatory framework for microfinance. The Government is key to the successful advancement of microfinance commercialization, which requires the following specific actions.

Stop the Provision of Subsidized, Directed Microcredit

Supply-led subsidized microcredit programs should be replaced by demand-led microcredit with interest rates that at least cover the costs of financial intermediation. The Government needs to shift resources from subsidized program credits to capacity building for expanded sustainable outreach by microfinance providers including banks, as well as for operators of microenterprises and small businesses.

One way to achieve greater consensus on the importance of market-driven microfinance and to build the political will to cease all subsidized microcredit programs might be to develop a national strategy for promoting sustainable microfinance. This would require key public and private stakeholders to come together to develop a comprehensive vision for commercialization of the microfinance industry as an integral part of general financial sector development. These stakeholders should then push for the necessary policy, legal, and regulatory changes to make it truly effective.

Strengthen BPR Regulation and Supervision

In order to expand BPR ability to branch and expand services to villages, consideration should be given to reducing the capital entry requirements for new BPRs and removing the requirement that new branches have the same capital requirements as for the head office. The prohibition of foreign investment in BPRs should be rescinded. BPRs should also be allowed to provide insurance services provided they do not take the underwriting risk. With GTZ assistance under the ProFI project, BI has worked to improve the regulatory regime for BPRs and the information flow to BI to make off-site supervision of BPRs more effective, and has substantially strengthened sanctions and penalties for noncompliance with regulations.

Other measures being considered are to increase capital adequacy ratios, develop a stricter loan classification system, increase loan-loss provisioning levels, simplify and improve the CAMEL rating system, and reduce legal lending limits. BI's board is likely to approve the new regulations in 2003. GTZ is already providing, and will continue to provide (during 2003–2005), comprehensive technical assistance to BI at the national and regional level to implement the new regulations, improve supervision, train supervisors, and improve manuals for on- and off-site inspection.

Formulate Activity-based Regulation and Supervision

Some adaptations of regulations for microfinance banks that should be considered include

- adjusting minimum capital requirements to be low enough to attract new entrants into microfinance, but high enough to ensure the creation of a sound financial intermediary;
- assessing the riskiness of microfinance operations based on overall portfolio quality and repayment history, rather than on the value of traditional guarantees;
- increasing capital adequacy ratios to 15–20%, depending on performance;
- requiring stricter loan loss provisioning; and
- allowing higher administrative cost ratios.

With the redefined role of BI, the Ministry of Finance should take the lead in promoting microfinance and considering the formulation of new activity-based regulation and supervision for microfinance. A special unit—or even directorate—for microfinance development in the Ministry of Finance may be required.

Improve the Legal and Regulatory Framework for Cooperatives

Cooperative laws and regulations should be reviewed with the following objectives:

- withdraw the Government from the cooperative sector and strengthen the institutional autonomy of microfinance cooperatives;
- terminate their preferential treatment and protection;
- strengthen participation of and internal control by members;
- limit savings mobilization and credit extension to ordinary members;
- establish an independent and effective supervisory regime; and
- abandon the explicit task of local officials to "motivate" small informal groups at the village level to convert to formal cooperatives.

Forced formalization should not be part of an enabling regulatory framework. Small, village-level groups need time to learn how to manage their own funds and often will not develop into larger financial intermediaries. It is neither desirable nor realistic that the state bureaucracy should oversee some 10,000 of these groups. An effective supervision system for microfinance cooperatives should be separate from the financial and technical support functions of the Ministry of Cooperatives and be able to enforce compliance with prudential regulations.

Assess the Feasibility of Establishing an Apex Bank for BPRs

To overcome some of the challenges associated with their unit bank structure, BPRs should explore the possibilities of linking to national or at least regional networks in order to allow interbank liquidity transfers and to provide their customers with possibilities of accessing their accounts in other areas of the country. Perhaps the most promising way to overcome the challenges associated with unit banking would be to open an apex bank for the system of BPRs. Such an apex bank could assist BPRs with liquidity and fund management and enable them to provide their clients with money transfer services. In addition, the apex bank might also assist in distributing costs related to training and systems development.

Facilitate the Provision of Deposit Insurance

Ongoing work to establishing a deposit insurance institution should be continued. To provide a more effective guarantee of savings, a team comprised of representatives from BI, the Ministry of Finance, and IBRA, has been appointed with the task of preparing for the establishment of the deposit insurance institution *Lembaga Penjamin Simpanan*, or LPS. The team's short-term agenda is to formulate a phaseout for the guarantee coverage on almost all bank obligations; it would be limited to savings, collections, incoming/outgoing transfers, interbank lending, and letters of credit. The long-term agenda is to establish the deposit insurance institution using limited guarantee coverage. Membership in the LPS is expected to be compulsory for all banks by 2004.

Improve BPR Institutional Capacity

Increased attention should be given to building human resource strength in financial analysis and banking so that strategic planning and business plans to operationalize such planning can be made. Active participation in *Perbarindo* should also take priority in order to exchange positive and negative experiences, learn about local and international best practices, and access various types of professional microfinance training services, such as the training program being supported by the ProFI project. Investments in human resource and product development are very costly and cannot be covered in the long-term by a single bank with a small capital base; thus access to support services is crucial for a BPR involved in microfinance. The development of strategic alliances with other financial institutions could also be a means to access these services at low cost.

Assess the Potential for Privatizing the BRI Units and PP

Both the BRI Units and PP operate on a profitable basis despite being public enterprises. Although BRI became a limited liability company in 1992, 100% of its shares are still owned by the State. Given the risks that the BRI Units face in terms of having their profits diverted by other divisions within BRI to unprofitable investments, the Government should give some consideration to the potential for at least partially privatizing the BRI Units in a way that will ensure maintenance of the system's focus on microfinance. One disadvantage of this would be that the Units may not have the same lucrative internal market for excess deposits. However, privatization may encourage them to move down-market for further lending. PP also appears ready for at least partial privatization because it is not only profitable but also able to raise funds in the domestic bond market. Thus, the Government should stop providing cheap funds to PP. The proceeds of divestiture could be used for social safety nets and/or for priority investments in physical infrastructure.

Promote the Establishment of a Local, Commercially-oriented Microfinance Training Center

The absence of a strong, commercially-oriented, microfinance training center is a major reason why microfinance retailing capacity remains low at institutions lacking an in-house training program. Creation of a “one-stop shop” could help the microfinance industry build the local technical capacity it needs for further professionalization and commercialization. Donors can help in this endeavor through their existing financial assistance, as discussed further below.

Invest in Social Intermediation and Rural Physical Infrastructure Development, Especially in Rural Areas

The Government should exchange direct interventions in poverty lending with indirect approaches, such as promoting the development of key microfinance industry support institutions and investing in social intermediation and infrastructure development. Short-term, subsidized microcredit interventions should be separated from social safety nets or emergency programs and replaced with longer-term, commercial strategies that support the balanced growth of savings, investment, and repayment capacities. Further development of physical infrastructure should focus on improving communications and transportation, which would reduce transaction costs and risks of microfinancial intermediation, especially in more remote rural areas. Social intermediation efforts should support microfinance commercialization by facilitating access to convenient and safe savings instruments that will allow low-income groups to manage their liquidity and accumulate funds for special expenditures.

ROLES OF FUNDING AGENCIES

The donor community, in close coordination with the Government, has several major roles to play in the commercialization of microfinance. As the industry develops, the roles of funding agencies will change in accordance with the aim of achieving increasing integration of the microfinance industry as an important subsector of the financial system.

Support an Enabling Policy Environment and Legal and Regulatory Framework

As market facilitators, donors should work with the Government to ensure an enabling environment for microfinance conducive to MFIs’ progress toward financial self-sufficiency. This includes advising on macroeconomic and sectoral policies conducive to the careful expansion of sustainable microfinance as an integral part of general financial sector development, as well as on the legal and regulatory framework for MFIs.

Build MFI Capacity and Facilitate Linkages

Emphasis must be given to institution building by strengthening management and market-orientation of MFIs; and helping the expansion of existing MFIs that are demand-driven and can fully cover operating costs, especially in underserved areas. Donors should promote institutionalized linkages between MFIs (i.e., by strengthening the GEMA PKM network) and also promote MFI cooperation with regional and international financial and technical service providers.

Promote the Establishment of a Local, Commercially-oriented Microfinance Training Center

As noted above, there is a clear need for a "one-stop shop" to help the microfinance industry build the local technical capacity it needs for further professionalization and commercialization. Donors should use a portion of their grant funds that currently support subsidized microcredit interest rates to finance at least part of the start-up costs of such a microfinance training center.

ROLES OF MICROFINANCE INSTITUTIONS

MFIs themselves have several roles to play in their commercialization and that of the industry. Common to all MFIs is the need to improve their institutional capacity to reach scale in their microfinance operations (through increasing depth and breath of outreach as well as financial self-sufficiency) and to strive continually for increasing operational efficiency. Several MFI-specific recommendations follow.

BRI Units

The overly risk-averse lending policy of the BRI Units should be reviewed with the objective of using more of their mobilized funds for microborrowers and low-income households, especially at the village level and in the eastern parts of Indonesia to the extent possible, while maintaining the Units' profitability and soundness. The Units should also use some of their considerable profits to develop innovative microfinance products and services to satisfy potential effective demand by agriculturally-based microentrepreneurs.

BPRs

As the performance of BPRs is extremely differentiated, perhaps their first priority should be to make efforts to improve their transparency in terms of internal financial monitoring and public disclosure of financial performance. This process is likely to bring to the surface the most pressing institution-specific concerns regarding what areas of BPR operations or infrastructure require improvement to enhance financial performance and to improve efficiency.

Microfinance NBFIs

Commitment to commercial microfinance needs to become more widely shared by NBFIs. Strengthening governance and internal control are two of the most pressing needs to ensure prudent handling of depositor funds. Some consolidation is needed to take advantage of economies of scale in provision of commercial microfinance, and most of the tiny NBFIs should consider mergers and formation of BPRs in order to expand their operations in a sustainable manner.

ROLES OF KEY SUPPORT INSTITUTIONS

Several types of support institutions can be considered as key in the development and growth of a microfinance industry. These include the networks and associations that support the wide range of MFIs, including banks, BPRs, LDKPs, BKDs, cooperatives, and credit unions. A common recommendation for the trade associations of various types is to facilitate independent business relationships and technical cooperation between commercial banks and MFIs as well as between capable MFIs and financial self-help groups. Specific roles for key support institutions include the following.

Microfinance Networks

The GEMA PKM network should continue participation in the process of developing an appropriate framework for microfinance regulation and supervision. The network should also initiate the establishment of performance standards that cut across all types of MFIs. Such performance standards would allow MFIs to compare their performance objectively and encourage their drive to improve efficiency and financial self-sufficiency.

Perbarindo

Perbarindo needs to be strengthened at the national and regional levels. It should continue to expand its offering of training and technical assistance in order to accredit staff and strengthen viable BPRs with respect to governance and internal control, funds mobilization, market research, credit analysis, and supervision.

BK3I

The BK3I board should establish a reliable database of cooperatives with microfinance activities; assess the viability of existing microfinance cooperatives; design and carry out pilot projects to strengthen the capacities of microfinance cooperatives toward self-reliance; support savings and credit associations to adopt the status of microfinance cooperatives, provided they are willing to do so; and strengthen the cooperative movement in building up independent secondary support structures. As a large federation, BK3I is in a good position to develop, from its large body of members, standardized accounting and performance reports that could eventually develop into a rating system.