

Executive Summary

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.

UNDERSTANDING 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 MFIs 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.

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

environment within which MFIs operate (commercialization of the microfinance industry).

At the micro level, MFI commercialization implies progress along a continuum, described as follows.

- Adoption of a for-profit orientation in administration and operation, such as developing diversified, demand-driven financial products and applying cost-recovery interest rates.
- Progression toward operational and financial self-sufficiency by increasing cost recovery and cost efficiency, as well as expanding outreach.
- Use of market-based sources of funds; for example, loans from commercial banks, mobilization of voluntary savings or other non-subsidized sources.
- Operation as a for-profit, formal financial institution that is subject to prudential regulation and supervision and able to attract equity investment.

At the macro level, commercialization of the microfinance industry means the increased provision of microfinance by MFIs sharing the above characteristics in an enabling environment. Commercialization of the microfinance industry involves several factors, including the degree to which the policy environment and the legal and regulatory framework are conducive to the development and growth of commercial MFIs, the availability and access of commercial MFIs to market-based sources of funds, and the existence of institutions that support the microfinance industry, such as apex institutions, credit information bureaus, microfinance trade associations, microfinance technical training centers, and providers of business development services.

PROGRESS TOWARD COMMERCIALIZATION

- The Indonesian microfinance industry is exceptionally old and the main suppliers are predominantly formal, savings-based MFIs.

The microfinance industry is characterized mainly by formal MFIs that have adopted a commercial approach and attained large-scale outreach with a high degree of financial self-sufficiency. The industry is very heterogeneous, but the regulated status of the largest MFIs has allowed them to have significant emphasis on microsavings in addition to microcredit. One of the best known institutions and the largest MFI in the world is the Bank Rakyat Indonesia's (BRI) Micro Business Division (hereafter referred to as the BRI Units). Although BRI is a 100% state-owned limited liability company (state bank), its financially self-sufficient network of more than 4,000 units had served around 27.0 million savers and 2.8 million borrowers profitably as of end-2001 and its high level of performance has been maintained through the Asian financial crisis of 1997–1998 to the present.

While the only microfinance windows of the banking sector with national coverage are the BRI Units, one private commercial bank, Bank Dagang Bali (BDB), has regional significance, with 31 branches and offices located mainly on the island of Bali. Other major commercial MFIs include 714 outlets of a state-owned pawning company (*Perum Pegadaian*, or PP) which in 2001 provided 22.2 million microloans to about 15.7 million clients and the 2,143 locally-owned people's credit banks (*Bank Perkreditan Rakyat*, or BPRs), which, on a combined basis, accounted for about 15% of the total microfinance market by number of microloans and microdeposits in 2001. Although the performance of the latter is extremely varied across institutions, the provision of microfinance by the system of BPRs is considered highly commercial because of their formality and reliance on deposits as their main source of funds.

- Several nonbank financial institutions are also important suppliers of microfinance at the subdistrict and village levels, but not all employ a commercial approach and their performance is extremely uneven.

The main semiformal MFIs include over 40,000 outlets of a variety of nonbank financial institutions (NBFIs). There are currently in operation approximately 4,518 village-owned village credit organizations (*Badan Kredit Desa*, or BKDs) that have been providing microfinance at the local level, particularly in rural Java, for more than 100 years. In addition, several types of rural fund and credit institutions (*Lembaga Dana Kredit Pedesaan*, or LDKPs) numbering now around 1,600, have been established on the initiative of provincial governments since the 1970s and are licensed, regulated, and supervised by the provincial governments. Also, approximately half of an estimated 40,000 active, licensed cooperatives and credit unions provide microfinance services.

Many individual entities within these semiformal NBFIs systems operate on a commercial basis and have good performance records in terms of outreach, financial self-sufficiency, and efficiency. As a whole, however, they cannot be classified as commercial due to extreme differences in ownership, management, and operations. For example, BKDs are owned and controlled by village governments and their performance varies directly with the ability of government officials to manage small-scale financial intermediation. In addition, one type of LDKP has evolved into competitive financial institutions (*Lembaga Perkreditan Desa*, or LPD) despite operating primarily in a province (Bali), which has the highest density of financial institutions in Indonesia, while other types of LDKPs have generally languished. Finally, the cooperative sector suffers from a lack of national-level data concerning its general operations in addition to its microfinance activities; many efficient informal credit unions do not seek to transform into semiformal cooperatives in order to avoid government interference with their generally more efficient microfinance operations.

- **Nongovernment organizations play a relatively minor role in microfinance provision.**

Only a few nongovernment organizations (NGOs) have made efforts to formalize their microfinance activities. Contrary to most other developing countries, NGOs in Indonesia have mostly been involved with providing training and other social services—social intermediation rather than financial intermediation. Although NGOs are forbidden to mobilize savings of members unless these are deposited in a regulated financial institution, a few NGOs have set up their own BPRs to overcome this constraint. As one of the oldest and largest NGOs in Indonesia, *Bina Swadaya* is perhaps the most prominent NGO to have established a licensed bank to carry out its microfinance activities. This NGO has established four BPRs over the last decade. Also, in at least one case, an NGO (*Yayasan Purba Danarta*, located in Semarang, Central Java) even managed to establish a locally-operated commercial bank, *Bank Purba Danarta*, in 1990. Another NGO (*Lembaga Penelitian dan Pengembangan Sumber Daya*, LP2SD) in East Lombok, West Nusa Tenggara, established its own credit cooperative, providing an umbrella for its savings and credit groups. However, the vast majority of NGO MFIs remains small and unsustainable, dependent on recurrent injections of donor funds to survive.

- **Government and/or donor supported microcredit or microfinance programs have had a mixed record in supporting microfinance commercialization.**

Since the 1970s, expanding the access to credit by the poor has been a major part of the Government's strategy to promote equitable growth and reduce poverty. A few interventions have helped the commercialization of microfinance by following the new "financial systems approach," but many microcredit programs based on the old paradigm of subsidized, directed credit have been harmful to the expansion of commercial microfinance. Perhaps the

largest of a number of high-cost, unsustainable microcredit programs was the 1993 Presidential Instruction on Backward Villages (*Inpres Desa Tertinggal*, or IDT) program coordinated by the National Development Planning Agency, BAPPENAS. Until it ended in 1997, the IDT program injected a total of about Rp1.3 trillion (more than \$550 million) into infrastructure development and poverty reduction, including substantial funds for unsustainable microcredit components. In addition, the Family Welfare Income Generation Project (*Usaha Peningkatan Pendapatan Keluarga Sejahtera*, or UPPKS) disbursed around Rp1.4 trillion (approximately \$200 million) in highly concessional loans with 6% annual effective interest rates and less than a 20% cumulative repayment rate.

The most positive interventions have focused on institutional strengthening and/or savings mobilization as a useful service for the poor and a large and stable source of funds for MFIs having clear legal status. A few, particularly market-friendly government and/or donor-sponsored programs, have been, in chronological order, the Rural Income Generation Project supported by the Indonesian Government, Asian Development Bank (ADB), and International Fund for Agricultural Development and implemented by the Ministry of Agriculture and BRI, as part of the *Proyek Peningkatan Pendapatan Petani-Nelayan Kecil* (Rural Income Generation Project, P4K) program in various forms since 1979; the transformation begun in 1983 of the BRI Units into a self-sustainable microfinance operation within BRI with technical support from the World Bank, United States Agency for International Development, and the Harvard Institute for International Development; the Microcredit Project implemented by Bank Indonesia (BI) with ADB technical assistance since 1996; and the Promotion of Small Financial Institutions (ProFI) project, also implemented by BI but with technical assistance support from the German Agency for Technical Cooperation (GTZ) from 1999. These experiences demonstrate how government policy toward microfinance has been highly inconsistent.

KEY ENABLING ATTRIBUTES OF THE OPERATING ENVIRONMENT

- **Financial sector deregulation begun in the early 1980s liberalized interest rates and set the stage for the transformation of BRI Units into a self-sufficient microfinance operation.**

One of the most important first steps Indonesian policymakers took to provide a conducive operating environment for commercial MFIs was to liberalize the interest rate in 1983, which set the stage for MFIs to charge cost-recovery interest rates and maintain spreads that allowed profitability. In addition, high-level political support for the transformation of BRI Units during 1983/84 from agricultural credit disbursement centers to a commercially-oriented system for micro and small-scale lending resulted in an increase in microfinance services for 27.0 million savers and 2.8 million borrowers as of end-2001.

- **A tiered legal and regulatory framework stemming from the 1988 banking reforms has allowed the expansion of unit (rural) banks 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 network throughout Indonesia. This reform package had the objective of expanding the outreach of financial services to rural areas. The Government also permitted the establishment of new secondary banks at the subdistrict level 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.

- **Recent regulations accommodating bank operations based on Sharia principles (Islamic banking) may open access to microfinance services for a new and potentially significant subset of the population.**

Banking Act No. 10 of 1998 and Banking Act No. 23 of 1999 have mandated and given legal basis for BI to develop Islamic banking in Indonesia, the world's most populous Muslim country. Islamic banking is based upon a renewed application of Islamic law, the Sharia, to modern economic and financial transactions. Beyond its religious implications, Islamic banking involves a conceptually different relationship between finance and economic activities. 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. This change in emphasis typically associated with Islamic banking may improve microcredit access by the poor who have cultural reservations to conventional credit or are without traditional collateral.

- **Since 1998, the Government has been endeavoring to strengthen BI significantly, 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, such as on loan loss provision requirements, minimum capital requirements, assessment of asset quality, legal lending limits, and financial reporting was designed to improve prudential banking practices in accordance with international standards.

Article 34 of Banking Act No. 23 of 1999 concerning BI mandated that there 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 a 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 NBFIs regulation and supervision. It is planned to be a government institution outside the cabinet, 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.” The coverage of the institution will include the supervision of banks and all NBFIs, such as insurance and venture capital companies, pawn companies, leasing companies, pension funds, security companies, and other financial service companies, including those mobilizing deposits from the public.

Many types of MFIs, such as BKDs, LDKPs, and other NBFIs without licenses as banks 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 comprised of representatives from the Coordinating Ministry of Economics, Ministry of Finance, Ministry of Cooperatives and Small and Medium Enterprises,

Ministry of Home Affairs, Ministry of Agriculture, National Development Planning Agency (BAPPENAS), BRI, a microfinance network called GEMA PKM (see below), and supported by the GTZ ProFI project, has been formulating a draft MFI Act since March 2001. 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 been receiving consideration since. The process is leading to appropriate regulation and supervision of microfinance in order to provide an enabling legal and regulatory environment for commercial MFIs and the protection of the savings of small depositors.

- **Several key industry support institutions have assisted the commercialization of a wide variety of MFIs.**

The most inclusive national microfinance network, the Indonesian Movement for Microfinance Development (GEMA PKM, *Gerakan Bersama Pengembangan Keuangan Mikro Indonesia*) has been an active partner in drafting new laws and regulations on microfinance and is committed to promoting awareness and adoption of best practices in microfinance as a tool for sustainable poverty reduction and economic growth. In addition, *Perbarindo*, the main national association of BPRs, has been providing training on microfinance for years and is now developing capacity-building tools in coordination with GTZ and BI to strengthen BPR performance and increase access to market sources of funds. Also, the Credit Union Coordination Board of Indonesia (BK3I), the national apex organization for the cooperative movement and its regional chapters, aims to strengthen the development of autonomous and self-reliant cooperatives. Training, insurance, interlending, and supervision are 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).

IMPLICATIONS OF COMMERCIALIZATION

- **Commercialization has allowed large-scale, sustainable microfinance 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. Savings mobilization by predominantly formal MFIs has fueled broad microcredit outreach. For example, at the end of 2001, savings mobilized by the BRI Units in the *Simpedes* savings product alone (Rp15.9 trillion, or \$1.5 billion) were 1.61 times the amount of their total outstanding loan portfolio (Rp9.8 trillion, or \$946.3 million). Deposit mobilization is also important for BPRs, which, on a combined basis, funded 90% of their outstanding loan portfolio (Rp5.6 trillion, or \$604.0 million) with deposits (Rp5.1 trillion, or \$534.6 million).

- **Microfinance commercialization has resulted in a wide scope of sustainable outreach.**

Various types of pawning services are readily available, as are flexible loan and deposit products and, to a lesser extent, payment and money transfer services. Perhaps most remarkable about the Indonesian experience is that commercialization has allowed the sustainable expansion of microsavings services on an unprecedented scale in addition to expanding access to microcredit. Commercialization has contributed to changing perceptions, at least on the part of practitioners, that microsavings are also a valuable service for the poor in addition to being a stable source of funds to support growth in the microloan portfolio. Importantly, the outreach of commercial MFIs has proven to be sustainable, and at no better time was this witnessed than during the Asian financial crisis.

- **Commercial MFIs have a good record in reaching the poor, although outreach coverage is incomplete in less populated rural areas.**

Although the average microcredit loan amount varies widely, the number and amount of microloans as a percentage of GDP per capita are less than most other microfinance markets in the world. Even the average outstanding loan size of the BRI Units (\$337), which is the highest among major commercial MFIs in Indonesia, is only half the GDP per capita (\$680) and low compared to the average for MFIs worldwide (\$453). The BRI Units and even some of the BPRs have had success in pioneering and expanding village units and mobile services in many areas. However, in general, commercial MFIs have had limited success in reaching down to the village level and to less populated areas.

- **Commercialization has not led to significant mission drift.**

Contrary to the common assumption that the process of MFI commercialization will shift an MFI's target market from the poor to the less poor and nonpoor (i.e., mission shift), this has not happened in Indonesia in any significant way. Indicators of mission drift include increasing effective interest rates charged on microloans, increasing average outstanding loan amounts, and change in percentage of low-income female clients to higher-income male customers. Few, if any, MFIs have exhibited these changes to any significant extent. This may be due in large part to the fact that more than 80% of the microcredit is supplied through the two state-owned institutions, PP and the BRI Units, that remain committed to the social mission of serving the economically-active poor. PP and the BRI Units operate on highly commercial terms when considering their delivery of demand-driven products, and use pricing that allows profitability and access to market-based sources of funds. Only their lack of private ownership prohibits consideration of these market leaders as fully commercial institutions.

- **Commercialization has not yet brought about competition.**

Competition between MFIs is not a factor so far, although some competitive pressures exist with banks

competing for deposits at the district level and above, and some localized competition is heating up in a few more highly populated subdistricts. The BRI Units' dominance as a nationwide unit system within a state-owned bank hinders competition and has made deposit mobilization and liquidity management by other MFIs, such as BPRs (having no transfer pricing mechanism and/or implicit government guarantee of deposits), more costly and difficult than if a level playing field existed.

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.

Constraints in the Operating Environment

- **Subsidized, directed microcredit programs that inhibit private sector microfinance initiatives**

A recent ADB report 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 microcredit or microfinance component. These programs have large funding allocations with their combined budget allocation in FY2002 alone amounting to Rp16.5 trillion (\$1.8 billion). Of the 70 total national government-sponsored poverty reduction programs, at least 16 were identified that address poverty issues under a long-term strategy of the Government, mostly

supported by such donors as the World Bank, ADB, and GTZ. These programs have a total budget of almost Rp3 trillion (\$330 million). Most of these also include a microcredit or microfinance component. Although well-intended, many of these programs do not follow established microfinance best practices and have undermined rather than supported sustainable microfinance. Specifically, they mix grants and credit, they do not clearly separate financial and social intermediation, and they frequently apply subsidized interest rates. In addition, following government deregulation, numerous and increasing district-level poverty reduction programs have been established that also contain microcredit or microfinance components adverse to the expansion of commercial microfinance. Both the national-level programs and regional or district-level programs have the potential to increase in the future given the upcoming 2004 elections and the possibility of using subsidized, directed microcredit programs to attract voters.

- **Deposits mobilized by NBFIs at risk**

With 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, institutional proliferation has led to market segmentation and a multitude of relatively weak MFIs at the village level. In some cases, the legal framework regarding this wide variety of NBFIs 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 for 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 may have collectively mobilized more than Rp1,871 billion (\$209 million) in deposits in recent years. If a significant amount of client savings were lost, it would be a challenge 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 and is not appropriate to the specialized operations of these microbanks. In some areas, the regulations are overly strict and in others 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 requirements stipulated by recent BPR regulations. BI Decree No. 32 (sections 35 and 36), enacted in May 1999, stated that the minimum capital requirement to establish a BPR or a branch is increased from Rp50 million to Rp2 billion (equal to \$192,308 at end-2001) for the national capital area.⁴ Simultaneously, BI increased minimum capital requirements to Rp1 billion (\$96,154) for provincial capitals and Rp500 million (\$48,077) for other areas. With a minimum paid-up capital 10 times higher than the previous capital requirement, new BPR establishment in rural areas is practically impossible. These high entry barriers contradict the idea of the banking reforms in 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 over the first 3 years following the increase in capital requirements. The 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.⁵

- **Political economy of cooperatives**

Provisions made in the Cooperative Law legalize direct government intervention into the cooperative sector and even require the Government to provide protection and preferential treatment. Their use to channel funds to targeted beneficiaries has completely corrupted the integrity of cooperatives as viable institutions. As long as this practice continues, it is 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 question. It requires a new political consensus in the post-New Order era about the role of the State in cooperative development, which should change from direct intervention to policymaking.⁶

- **Gaps and deficiencies in cooperative law**

There exists a basically sound regulatory framework for the primary and secondary savings and credit cooperatives (*Koperasi Simpan Pinjam*, or KSPs) and savings and credit units (*Unit Simpan Pinjam*, or 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, 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 (Capital, Asset, Management, Equity, and Liquidity) 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 and Small and Medium Enterprises to supervise or even to guide KSPs/USPs. In addition, deposit protection applies only to banks. 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 in order 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.⁸ However, behind this success is the large financial 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**

The exchange of information between the BPRs, BRI Units, and BI is common, although done on an ad hoc basis. Typically, the BPRs ask BRI or other BPRs whether or not a 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, BI, at the end of March 2000, conducted a reorganization at the Directorate of Credit, which formerly comprised five divisions, into a Credit Administration and Management Division with a Development Team to create a credit information system. BI saw the need to formulate 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 a local microfinance training institution**

Quality training at reasonable prices for both MFI managers and line staff to promote management and retailing capabilities in line with best practices in

microfinance is virtually nonexistent in Indonesia. Although BRI conducts some training courses and BPR-specific training is provided by *Perbarindo*, there is no “one-stop shop” for quality, demand-driven and cost-effective training in microfinance on a regular basis.

Internal Constraints to MFI Commercialization

- **BRI Units**

The achievements of the BRI Units in terms of financial self-sufficiency and outreach have been without parallel elsewhere in the world, but they also have a few important shortcomings 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 and at no time was this made clearer than during the recent Asian financial crisis. 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.

- **BPRs**

BPR outreach is concentrated in urban areas of Java and Bali provinces (comprising some 82% of the total number of BPRs).⁹ Outreach into outlying provinces and their rural areas is very limited. The main constraint to expanding the BPR industry into new regions and markets relates to the high minimum capitalization requirements that limit the ability of BPRs to form branches. Lack of a network also poses a constraint to BPR expansion in terms of ability 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.

- **LDKPs**

Ownership of LDKPs by traditional village administrative units called *Desa Adat* suffers from

communal conflicts that affect management and operations; also weak enforcement ability in some cases undermines good performance. In addition, structural weakness of the support system available to LPDs in need of technical assistance affects potential growth opportunities. Supervision of LDKPs is not clearly separated from technical assistance to these institutions and involves too many parties to be effective. The lack of consistent national regulatory framework is another constraint. The former requirement to convert LDKPs to BPRs did not reflect the needs of such institutions as LPDs. This led BI to allow LPDs to operate temporarily as nonbanks without solving the underlying problem of uneven performance by LDKPs as a whole.¹⁰

- **BKDs**

As ownership and legal form are vague, and management and control functions are not clearly separated, BKDs lack effective governance and supervision by owners. Although the BKD industry has comparative advantages in operating on a part-time basis within a limited and familiar environment, the BKD industry as a whole is held back by a lack of dynamism. In addition, BKDs lack strong market orientation, skilled human resources, and the systems required for small banks.¹¹

**POSITIVE APPROACHES TO
COMMERCIALIZATION**

- **Stop the provision of subsidized, directed microcredit.**

The main roles that the Government should play in the commercialization of microfinance are to create and maintain an enabling macroeconomic and sectoral policy environment and an appropriate legal and regulatory framework for microfinance. 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 credit programs to capacity building for expanded sustainable outreach by microfinance providers including banks, as well as for operators of microenterprises and small businesses.

- **Strengthen BPR regulation and supervision.**

To expand the ability of BPRs 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. This work should continue with a view to increasing capital adequacy ratios, developing a stricter loan classification system, increasing loan-loss provisioning levels, simplifying and improving the CAMEL rating system, reducing legal lending limits, improving the information flow to BI to make off-site supervision more effective, and substantially strengthening sanctions and penalties for noncompliance with regulations. 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 facilitate 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 establish a deposit insurance institution should be continued. To provide a more effective guarantee of savings, a team comprised of representatives from BI, Ministry of Finance, and Indonesian Bank Restructuring Agency 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 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. Therefore, 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 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 a microfinance training center. In addition, 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.

- **Invest in social intermediation and 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 support institutions and investing in social intermediation 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. The emphasis of social intermediation efforts should be support for microfinance commercialization by

helping access to convenient and safe savings instruments, which allow low-income groups, including the extremely poor, to manage their liquidity and accumulate funds for special expenditures.