

# COMMERCIALIZATION OF MICROFINANCE

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## INDONESIA

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Asian Development Bank

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## FOREWORD

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The microfinance industry has evolved significantly over the past two decades. However, the outreach of the industry remains well below its potential in the Asia and Pacific region. If the full potential of microfinance for poverty reduction is to be realized, it is essential to expand its outreach substantially. It is in this context that commercialization of the industry has become a subject of in-depth study. Although many industry stakeholders appear to believe firmly that commercialization is necessary, there is inadequate understanding of the complex process of moving toward a sustainable microfinance industry with a massive outreach.

The Microfinance Development Strategy of the Asian Development Bank (ADB), approved in June 2000, provides a framework for supporting the development of sustainable microfinance systems that provide diverse, high-quality services to traditionally underserved low-income or poor households and their microenterprises. One element of this strategy is support for development of viable microfinance institutions that can set in motion a process of commercialization of microfinance services. As a first step, ADB approved in November 2000 a regional technical assistance project on Commercialization of Microfinance, to improve understanding of the process of microfinance commercialization as well as its challenges, implications, and prospects. The project, which was financed from the Japan Special Fund, has three components: country studies on microfinance commercialization, in-country workshops to discuss the country studies and specific institutional experiences, and a regional workshop to discuss each country study and institutional experiences in a comparative context.

The countries chosen for study—Bangladesh, Indonesia, Philippines, and Sri Lanka—represent different stages of development and commercialization of the microfinance industry.

The Indonesia country study was carried out by Stephanie Charitonenko of Chemonics International, Inc. and Ismah Afwan, an independent consultant. Their report, presented here, was first presented at the Country Workshop on Commercialization of Microfinance, 12–13 March 2003, Mulia Hotel Senayan, Jakarta. Workshop participants provided valuable input to refine the report and improve its relevance.

This publication is one of a series of papers resulting from the project. The series comprises four country reports (on Bangladesh, Indonesia, Philippines, and Sri Lanka, respectively) and a regional report covering these countries.

It is hoped that this publication series will contribute to a better understanding of the issues involved in commercialization of microfinance and lead to better approaches toward a sustainable microfinance industry that will provide a wide range of services to low-income and poor households not only in the Asia and Pacific region but also in other regions.

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## ABBREVIATIONS

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|          |  |
|----------|--|
| ADB      | Asian Development Bank   |
| BAPPENAS | <i>Badan Perencanaan Pembangunan Nasional</i> , or National Development Planning Agency                            |
| BI       | Bank Indonesia   |
| BDB      | <i>Bank Dagang Bali</i>  |
| BKD      | <i>Badan Kredit Desa</i> , or village credit organization  |
| BK3I     | <i>Badan Kredit Koperasi Kredit Indonesia</i> , or Credit Union Coordination Board of Indonesia                    |
| BPD      | <i>Bank Pembangunan Daerah</i> , or regional development bank  |
| BPR      | <i>Bank Perkreditan Rakyat</i> , or people's credit bank   |
| BRI      | <i>Bank Rakyat Indonesia</i> , or People's Bank of Indonesia   |
| CAMEL    | Capital, Asset, Management, Equity, and Liquidity  |
| GDP      | gross domestic product   |
| GEMA PKM | <i>Gerakan Bersama Pengembangan Keuangan Mikro Indonesia</i> , or Indonesian Movement for Microfinance Development |
| GTZ      | German Agency for Technical Cooperation  |
| HIID     | Harvard Institute for International Development  |
| IBRA     | Indonesian Bank Restructuring Agency   |
| KSP      | <i>Koperasi Simpan Pinjam</i> , or savings and credit cooperative  |
| LDKP     | <i>Lembaga Dana Kredit Pedesaan</i> , or rural fund and credit institution   |
| LPD      | <i>Lembaga Perkreditan Desa</i> , or Village Credit Institution  |
| MFI      | microfinance institution   |
| NBFI     | nonbank financial institution  |
| NGO      | nongovernment organization   |
| P4K      | <i>Proyek Peningkatan Pendapatan Petani-Nelayan Kecil</i> , or Small Farmers' Income Generation Project            |
| PP       | <i>Perum Pegadaian</i>   |
| ProFI    | Promotion of Small Financial Institutions project (GTZ)  |
| RIGP/P4K | Rural Income Generation Project, 3 <sup>rd</sup> phase of P4K  |
| UNDP     | United Nations Development Programme   |

|       |  |
|-------|--|
| USP   | <i>Unit Simpan Pinjam</i> , or savings and credit unit |
| USAID | United States Agency for International Development     |

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**CURRENCY EQUIVALENTS**  
(AS OF MAY 2003)

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|               |   |             |
|---------------|---|-------------|
| Currency Unit | – | Rupiah (Rp) |
| \$1.00        | = | Rp9,000     |
| Rp1           | = | \$0.0001    |

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PREVIOUS YEARS

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|      | Year-End | Year Average |
|------|----------|--------------|
| 1992 | 2,067    | 2,033        |
| 1993 | 2,102    | 2,089        |
| 1994 | 2,199    | 2,163        |
| 1995 | 2,287    | 2,247        |
| 1996 | 2,344    | 2,329        |
| 1997 | 3,646    | 2,776        |
| 1998 | 8,000    | 10,248       |
| 1999 | 7,100    | 7,787        |
| 2000 | 9,675    | 8,527        |
| 2001 | 10,400   | 10,271       |
| 2002 | 8,940    | 9,318        |

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**NOTES**

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- (i) The fiscal year (FY) of the Government ends on 31 December. In this report, “FY” before a calendar year denotes the year in which the fiscal year ends, e.g., FY2000 ends on 31 December 2000.
- (ii) In this report, “\$” refers to US dollars.

# Executive Summary

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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.

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## UNDERSTANDING MICROFINANCE COMMERCIALIZATION

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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.

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## PROGRESS TOWARD COMMERCIALIZATION

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- 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.

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**KEY ENABLING ATTRIBUTES OF THE OPERATING ENVIRONMENT**

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- **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).

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## IMPLICATIONS OF COMMERCIALIZATION

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- **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.

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### **MICROFINANCE COMMERCIALIZATION CHALLENGES**

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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.<sup>4</sup> 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.<sup>5</sup>

- **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.<sup>6</sup>

- **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.<sup>8</sup> 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).<sup>9</sup> 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.<sup>10</sup>

- **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.<sup>11</sup>

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**POSITIVE APPROACHES TO  
COMMERCIALIZATION**

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- **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.

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.

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## METHODOLOGY AND ORGANIZATION

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This study on which this report is based includes theoretical considerations drawn from the “financial systems” paradigm<sup>12</sup> and practical field experience for analyzing the commercialization of microfinance. The main findings and recommendations presented here are the product of extensive consultation through individual and group meetings with a wide variety of MFIs and stakeholders including microfinance clients, government officials, state-owned commercial banks, private banks, cooperatives, domestic and international nongovernment organizations (NGOs), funding agencies, and academics. In addition, because of the extreme diversity and numbers of MFIs operating at the village level throughout Indonesia, this study relies heavily on existing microfinance literature.

Responses to questionnaires eliciting stakeholder views on microfinance commercialization and their latest institutional and financial data have been incorporated

where possible. In addition to collecting such data and holding a wide variety of stakeholder meetings in Jakarta, the authors also gathered data during field visits to several other provinces.<sup>13</sup> It is important to note that all institutional and financial data are based on self-reporting by the MFIs surveyed by the authors, unless otherwise noted. Readers should be mindful that these self-reported data provided by MFIs and included in this report are often based on estimates only. This is particularly an issue with NGOs providing microfinance (microfinance NGOs) that do not separate microfinance from other social programs or from traditional financial intermediation (as with many banks and cooperatives).

The remainder of this chapter elaborates on the framework for analyzing the commercialization of microfinance used throughout the study and establishes the country context as it affects the microfinance industry. Chapter 2 examines the historical development of the microfinance industry, evaluates major commercial MFIs and microfinance programs, and assesses MFI access to commercial sources of funds. Chapter 3 analyzes the conduciveness of the operating environment to the commercialization of microfinance by focusing on enabling attributes of the policy environment and the legal and regulatory framework, and the existence of key microfinance support institutions. Chapter 4 explores the implications of commercialization in terms of expected changes in access to microfinance by client type, in the mix of microfinance products and services offered, and in access to commercial sources of funds. Empirical evidence of and potential for competition and mission drift are also assessed in Chapter 4. Current challenges to microfinance commercialization are the focus of Chapter 5, which reveals stakeholder perceptions, internal constraints facing MFIs, and external

impediments in the operating environment. Chapter 6 recommends positive approaches to commercialization for the Government, funding agencies, various types of MFIs, and microfinance support institutions.

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### FRAMEWORK FOR ANALYZING MICROFINANCE COMMERCIALIZATION

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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 players 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. The term *commercialization* in Indonesia carries a negative connotation and is perceived more to indicate excessive profitability than sustainability. This concept of commercialization is distinct from the favorable one held by many microfinance professionals worldwide.

International microfinance professionals are increasingly considering commercialization to be “the application of market-based principles to microfinance” or “the expansion of profit-driven microfinance operations.”<sup>14</sup> There is a growing realization in the international arena that commercialization allows MFIs greater opportunity to fulfill their social objectives of providing the poor with increased access to an array of demand-driven microfinance products and services. In Indonesia, however, euphemisms such as “surplus” are traditionally used in place of “profit” and institutional sustainability is used as an acceptable catch-all phrase indicating many of the principles of commercial microfinance elaborated in this study. Few Indonesian stakeholders hold the

view that commercialization allows MFIs greater opportunity to fulfill their social objectives of providing the poor with increased access to an array of demand-driven microfinance products and services (including not only credit but also savings, insurance, payments, money transfers, etc.).

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

### MFI Commercialization

MFI commercialization is considered as progress along a continuum, as depicted in Figure 1.1 and described below.

- Adoption of a professional, business-like approach to MFI administration and operation, such as developing diversified, demand-driven microfinance products and services and applying cost-recovery interest rates.
- Progression toward operational and financial self-sufficiency by increasing cost recovery and efficiency, as well as expanding outreach.
- Use of commercial sources of funds; for example, nonsubsidized loans from apex organizations (wholesale lending institutions) or commercial banks, mobilization of voluntary savings, or other market-based funding sources.
- Operation as a for-profit, formal<sup>15</sup> financial institution that is subject to prudential regulation and supervision and able to attract equity investment.

Progress toward MFI commercialization is usually hastened by a strategic decision of an

MFI's owners/managers to adopt a for-profit orientation accompanied by a business plan to operationalize the strategy to reach full financial self-sufficiency and to increasingly leverage its funds to achieve greater levels of outreach. The recognition that the key to achieving substantial levels of outreach is building a sound financial institution, essentially means that MFIs need to charge cost-covering interest rates and continually strive for increasing operational efficiency.

Advocates of this approach rightly argue that charging cost-covering interest rates is feasible because most clients would have to pay, and indeed do pay, even higher interest rates to informal moneylenders. MFIs that charge cost-covering interest rates are an attractive option for this clientele even though the interest rates that an MFI might charge may seem high relative to the corresponding cost of borrowing from a commercial bank. The relevant basis for interest rate comparisons in the eyes of the client is the informal sector where he or she usually can access funds, not the commercial banking sector, which rarely serves this market.<sup>16</sup>

As an MFI's interest and fee revenue covers first its operating costs and then the cost of its loanable funds, it may be considered to be increasingly operating on a commercial basis. MFI profitability enables expansion of operations out of retained earnings or access to market-based sources of funds. Operating as a for-profit, formal financial institution may be the most complete hallmark of MFI commercialization because this implies subjectivity to prudential regulation and

supervision and that the MFI has become fully integrated into the formal financial system. However, MFIs strive for varying degrees of commercialization; not all aim to become formal financial institutions. This decision is usually closely linked to a host of external factors affecting the commercialization of microfinance, discussed next.

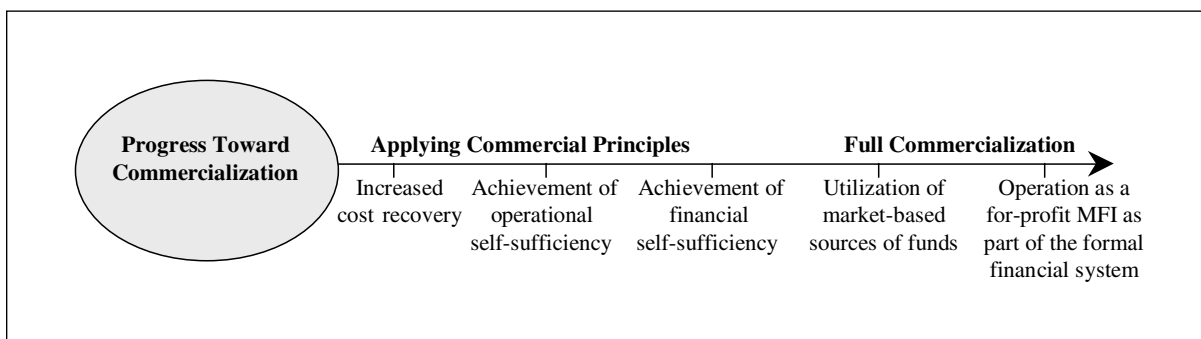
### Commercialization of the Microfinance Industry

Commercialization of the microfinance industry involves several factors including the degree to which the policy environment is conducive to the proliferation of commercial MFIs, the extent to which the legal and regulatory framework supports the development and growth of commercial MFIs, the availability and access of commercial MFIs to market-based sources of funds, and the existence of key support institutions. The main elements of the operating environment that determine the commercialization of the microfinance industry can be divided into the following five categories.

#### 1. Policy Environment

- Government policies that impede the ability of MFIs to progress toward commercialization (examples of such policies are interest rate caps and selective, ad hoc, debt-forgiveness programs).

**Figure 1.1: Attributes of MFI Commercialization**



- Subsidized (government or donor-supported) microcredit programs that may inhibit the development and growth of commercial MFIs.

## 2. Legal Framework

- The legal framework for secured transactions (the creation [legal definition], perfection [registration], and repossession [enforcement] of claims) as well as for microenterprise formation and growth.<sup>17</sup>
- The licensing options available to new MFI entrants or semiformal MFIs interested in transforming into formal financial institutions.

## 3. Regulation and Supervision

- The prudential regulations and supervision practices that govern MFIs mobilizing voluntary public deposits specifically or financial institutions in the broader financial markets generally, and the institutional capacity of the regulating body to carry out its mandate effectively.

## 4. Money Markets and Capital Markets

- Availability and access of MFIs to commercial sources of funds, such as unsubsidized loans, from apex organizations (wholesale lending institutions) or banks; mobilization of voluntary savings, private investment funds, or other market-based funding sources.

## 5. Support Institutions

- Existence of credit information collection and reporting services, such as credit information bureaus and credit rating agencies, that capture information useful to MFIs regarding borrower creditworthiness, loans outstanding, types of collateral pledged, etc.; or to potential MFI investors. Examples include ratings of MFIs based on their portfolio quality and asset values, microfinance trade

associations and networks, local microfinance technical assistance providers and training institutions, and domestic providers of business development services.

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## NATIONAL CONTEXT

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Socioeconomic development and macroeconomic and sectoral stability are important considerations in determining suitability of the operating environment to promote growth of the microfinance industry and its possible commercialization. This section presents the social development indicators for Indonesia, its recent macroeconomic performance, and that of the country's agricultural and financial sectors as a basis for establishing the national context for the commercialization of microfinance.

### Socioeconomic Indicators

#### *Population, Geography, and Infrastructure Development*

The world's largest archipelago, Indonesia has a total population of about 214 million people<sup>18</sup> inhabiting around 6,000 islands (out of a total of over 17,000). With a total land area of 1.8 million square kilometers (km<sup>2</sup>), Indonesia has a deceptively low population density ratio of about 117 people per km<sup>2</sup>. However, the three most populous islands of Java, Bali, and Madura support more than 60% of the country's population on less than 10% of the land mass.<sup>19</sup> This difference in population density contributes to distinctions between the three larger "inner islands" and all the other, smaller "outer islands" in terms of provision of physical infrastructure and social services. This uneven distribution of population and infrastructure contributes to significant differences in effective demand for microfinance between and within regions and in terms of the cost structures for MFIs. Hence, to provide microfinance on a commercial basis, one has to adapt products and services to local demand and adjust interest rates to reflect the costs of doing business in a particular area.

## Social Indicators and Poverty

According to the United Nations Development Programme (UNDP) 2002 Human Development Report, Indonesia is classified as a “medium-level country” and it ranked 110 out of 173 countries.<sup>20</sup> Reflecting decades of significant economic and social investment by the Government, UNDP’s Human Development Index for the country rose from 0.591 in 1985 to 0.684 in 2000 and most social development indicators reflect similar positive trends (see Annex 1 for detailed data). However, while Indonesia’s progress in key social indicators, such as contraceptive use rate and child mortality, was good, it has lagged behind in others, such as secondary school enrollment, maternal mortality, and communicable diseases.<sup>21</sup> Most human development indicators are commensurate with those of other East Asian countries; however, the Asian financial crisis<sup>22</sup> of 1997–1998 arguably hit Indonesia hardest and the adverse social effects of it, such as decreased school enrollments and stubbornly low health indicators, linger. In addition, the higher Human Development Index masks persistent gender inequalities. Female illiteracy is still considerably higher than male illiteracy (20% and 9%, respectively), although the gap has narrowed considerably. Women remain concentrated in low-skill, low-paid employment. Of workers officially recorded as “unpaid family workers,” 71% are women. Home-based workers, who are predominantly women, are deprived of basic rights, benefits, and job security; and wages are usually extremely low.<sup>23</sup>

The Government managed to decrease the proportion of the population living in poverty over the last 20 years from 40.1% in 1976 to around 17.6% or 34 million people in 1996.<sup>24</sup> At the peak of the crisis, however, the Asian Development Bank (ADB)<sup>25</sup> estimated that perhaps an additional 15 million people fell below the poverty line, showing the vulnerability of poor and near-poor households to economic shocks. The proportion below the poverty line stood at 18.2% in 1999 (Annex 1). Box 1.1 provides a profile of the poor, who are mostly uneducated, rural laborers. While the informal sector of the

### Box 1.1

#### Characteristics of Indonesia’s Poor

- Only 5% of the poor have a secondary education or better—87% live in households in which the head of the household has only a primary education or less.
- For almost 60% of the poor, agriculture provides the main source of income (whether from labor or land).
- More than 75% of the poor live in rural areas.
- Most of the poor (61%) live on Java.
- Nearly 80% of the poor (and 50% of the nonpoor) lack access to improved water sources. Access to sanitation is even more limited.

Note: Figures are based on 1999 data.  
Source: World Bank 2001, p6.

economy was estimated to include about 50 million microentrepreneurs before the crisis, it is widely believed to have expanded due to the influx of laid-off workers trying to earn income through self-employment.<sup>26</sup>

While access to microfinance was important before the crisis, especially for women, MFIs over the last few years have become even more significant because traditional commercial lending was severely curtailed by the collapse of the banking sector in the late 1990s. Given the importance of the informal sector, access to commercial microfinance, especially microsavings, has provided a valuable social safety net for the poor and near poor, and helped many people start businesses. Because of this, commercial microfinance is increasingly lauded for supporting the resilience of the national economy during the crisis and at present.<sup>27</sup>

## Policy Priorities and Economic Growth

Continuing the economic recovery from the Asian financial crisis is the Government’s first priority. Related, chief concerns of the Government, which transitioned to a democracy

in 1999 after 4 decades of authoritarianism, are addressing charges of government corruption and cronyism and resolving growing separatist movements in several parts of the country. Increasing security threats and unease about the Government's slow pace of International Monetary Fund-mandated economic reforms have contributed to heightened investor uncertainty and weakened foreign direct investment.

Real gross domestic product (GDP) growth fell to 3.3% in 2001 from a strong 4.9% in 2000.<sup>28</sup> Although inflation spiked during the Asian financial crisis, it has remained relatively low and stable over the last 3 years (detailed economic indicators are included in Annex 2). Increases in private consumption and public expenditure accounted for most of the GDP growth in 2001, offsetting emerging weaknesses in business investment and external markets.<sup>29</sup> Income growth in 2000 signaled the end of the long recession stemming from the crisis. Solid wage increases followed for manufacturing and service sector employees. Large increases in minimum wages in 2000 and 2001 encouraged spending by some families. Gross national income per capita in 2001 was \$680 (using the Atlas method) but this average figure masks significant disparities between low- and high-income families.<sup>30</sup>

Rural populations, suffering from stagnant agricultural productivity, and those in the large informal sector saw little income growth.<sup>31</sup> While real GDP growth was higher than that for many other countries in the region, it was not adequate to provide jobs for new entrants of the labor force. The unemployment rate in 2001 increased to an estimated 6.7–7.0% compared with 6.1% in the previous year. With a labor force growing at about 2.7% per year, Indonesia's economy will need to grow even faster to reduce poverty.<sup>32</sup> Continued economic recovery from the Asian financial crisis and maintenance of low and stable inflation will be essential ingredients to allow expanded MFI provision of commercial microfinance.

## Agriculture Sector Development

The rural sector contains the largest segment of the poor and almost 60% of the poor rely on agriculture for their main source of income. Agriculture provided employment for more than 43% of the labor force in 1999, and agriculture and natural resources are the basis for much manufacturing, especially for export markets.<sup>33</sup> However, agriculture as a share of GDP is declining, falling from 23.4% in 1981 to 16.4% in 2001.<sup>34</sup>

Although agriculture's share of the economy is small compared to that of industry (which was 46.5% of GDP in 2001), increased agricultural productivity during the 1980s "created many opportunities for informal off-farm economic activities with consequent burgeoning demand for microfinance in the rural economy, especially on Java and Bali."<sup>35</sup> Agricultural growth in Indonesia averaged about 3.8% annually in the 1980s, approximately 2% higher than the rate of rural population growth. Between 1990 and 1995, however, the rate of agricultural growth slowed to 2.9%, and was negative during the Asian financial crisis and under the impact of successive occurrences of the El Niño weather pattern. The labor productivity (and income) gap between the agriculture and nonagriculture sectors widened over that period, contributing to increases in poverty. Per capita GDP in the nonagriculture sector in 1995 was almost five times higher than in agriculture.

The decline in average farm size and the low level of capital available to such small farms are major problems that complicate efforts to improve agricultural productivity. Other major constraints to agricultural development include old technologies, inadequate resources, deficient infrastructure, weak social capital, and a constraining policy and institutional environment.<sup>36</sup> Nevertheless, these issues must be addressed to ensure that appropriate farming systems are developed to realize the comparative advantages of the diverse localities of Indonesia.

Increasing agricultural productivity as part of a general rural development program is the key to opening many isolated areas to development. Sharply altered terms of trade since 1997 suggest greater opportunities for export-oriented crops. Technology transfer, raising the productivity of agriculture, and rural nonfarm activities can lead to diversified agriculture in line with contemporary terms of trade and production costs.<sup>37</sup> Investment to raise agricultural productivity holds the potential for increasing the effective demand for microfinance (in terms of both microcredit and microsavings) by agribusinesses, thereby expanding the market base for commercial MFIs interested in exploring new client niches.

## Financial Sector Development

### *Composition of the Formal Financial Sector*

Indonesia's formal financial system is composed of banks and nonbank financial institutions (NBFIs). The Ministry of Finance and the central bank—Bank Indonesia (BI)—are the primary government bodies regulating and supervising Indonesia's financial system and institutions, including banks. The Ministry of Finance's principal responsibilities are to establish banking sector policies and exercise financial management on behalf of the Government. BI's main functions are to maintain currency stability, issue new bank licenses, establish prudential regulations for banks, regulate the payments system, and conduct interbank clearing and settlement.

The Banking Act No. 7 of 1992 recognizes two types of banks: commercial banks, or primary banks permitted to offer the full range of banking services; and secondary banks, the *Bank Perkreditan Rakyat* (literally, “people’s credit banks,” usually translated as “rural banks” and identified as BPRs), with services limited to the provision of credit, savings, and time deposits. At the end of 2001, there were 145 commercial banks with a combined number of bank offices at 6,765.<sup>38</sup> Five state-owned banks controlled half the total banking sector assets. The total number

of BPRs was 7,703 with 81 of them operating under Sharia (i.e., Islamic banking) principles.<sup>39</sup> In addition, there are two types of NBFIs: those engaged primarily in capital market activities and the rest—finance companies, venture capital companies, insurance companies, and pension funds. The former are regulated and supervised by the Capital Market Supervisory Agency (*Bapepam*), while the latter are supervised by the Ministry of Finance with assistance in some cases from BI.<sup>40</sup>

### *Continued Recovery of the Banking Sector*

The Asian financial crisis was most dramatically reflected in Indonesia in the breakdown of the banking sector, with many banks being liquidated and most of the others surviving only as a result of a massive restructuring program implemented by the Government. An important early move by the Government in January 1998 was its blanket guarantee of deposits and creditor claims. Guaranteed bonds amounted to Rp164.5 trillion in 1998 alone (\$20.6 billion).<sup>41</sup>

The restructuring program as a whole essentially saved the industry from complete collapse through the issuance of Rp432 trillion (\$54 billion) of government obligations in total from the end of 1998 through October 2000. Since the crisis, several institutions have been established to help the two monetary authorities manage the bank restructuring and the recovery of nonperforming loans. These new institutions include the Indonesian Bank Restructuring Agency (IBRA) and the Assets Management Unit, which is a part of IBRA. In addition, an independent agency is supposed to be established soon to focus specifically on the supervision of the banking system.

Extensive restructuring and recapitalization of banks following the financial crisis have helped the banking system become more stable and financially healthy. Initial steps have also been taken toward reducing government ownership of banks and encouraging the recovery of lending to support economic activity. The Government provided support to recapitalize state-owned and

other selected banks throughout 1999 and 2000 to achieve a minimum 4% capital adequacy ratio (CAR). Following that, BI required all banks to meet a minimum 8% CAR by end-2001. Most of the 151 commercial banks achieved this target. Some of those that did not are being encouraged to merge with stronger institutions. BI aims to reduce the level of nonperforming bank loans eventually to a maximum of 5%. Despite some concerns regarding the consistency of asset classification between banks, the overall bank nonperforming loan ratio declined from 18.8% at end-2000 to 12.1% at end-2001.

Bank recapitalization has left most of the largest banks with a substantial portion of their assets in government recapitalization bonds, and loan portfolios substantially reduced following the transfer of selected nonperforming loans to IBRA. The loan-to-deposit ratio of all banks fell from more than 100% in 1997 to only 36% at end-1999. Lending, however, recovered somewhat

during 2001: bank credit grew 33%, albeit from a low post-crisis basis, and the overall loan-to-deposit ratio had risen to 45% by end-2001.<sup>42</sup> Reflecting reduced inflation and continued recovery of the economy, the weighted, average interest rate of 1-month BI certificates continued to decrease in 2002, dropping from 15.11% in the second quarter to 13.22% in the third quarter. The interbank overnight interest rate also declined about 1.51% to 12.62%. These rate cuts were also followed by a gradual decline in time deposit rates and bank lending rates.

While Indonesia has made good progress in restructuring and recovering from the banking crises of the 1990s, it still has a way to go before there will be profitability and significant competition in the banking sector. Until then, the formal banking sector will likely continue to stay away from direct lending to microenterprises or small businesses or supporting MFIs through loans or refinancing facilities.

## 2 Progress toward Microfinance Commercialization

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This chapter focuses on the progress of Indonesian MFIs toward commercialization as a whole and by institutional type. A historical overview of the establishment and development of the various types of MFIs in Indonesia is provided and their current collective and individual performance is summarized in terms of outreach, financial self-sufficiency, and efficiency.

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### HISTORICAL OVERVIEW

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The Indonesian microfinance industry is exceptionally old and is one of the most commercialized in the world in terms of its provision of sustainable microfinance with large scale and sustainability of outreach. The industry is very heterogeneous but the biggest players are predominantly formal (regulated by BI) and savings based. One of the best known, because of its status as the largest MFI in the world, is the Bank Rakyat Indonesia's (BRI) Micro Business Division (referred to as BRI Units). Also important is Bank Dagang Bali (BDB) as one of the first, if not the first commercial bank established primarily to serve low-income and poor clients.

The BRI Units were established in the early 1970s as outlets under the *Bimbingan Massal* (BIMAS, or Mass Guidance) program of directed credit for rice intensification. The BIMAS credit program had essentially accomplished its goal of making Indonesia self-sufficient in rice production in the mid-1970s. By the early 1980s, however, the program was becoming increasingly unsustainable, due to subsidized interest rates, poor loan repayment, and employee incentives directed toward disbursing credit rather than generating profits.

In 1983, declining budgetary revenues resulting from lower oil prices, together with increasing expenses under BIMAS due to deteriorating loan collections, led the Indonesian Government to radically transform the BRI Units—with technical support from the World Bank, United States Agency for International Development (USAID), and Harvard Institute for International Development (HIID)—into a self-sustainable microfinance operation within BRI. With a relatively small initial subsidy in 1983, and the launching of a simple, but appropriately designed and priced microcredit product in 1984 called the *Kupedes* (general rural credit), the Unit system became profitable within just 18 months. Three years later, deposit services, including the extremely successful *Simpedes* savings product, were added to the BRI Units' microfinance product mix. Although BRI remains a 100% state-owned limited liability company (state bank), its Unit system operates in a commercial manner with a financially self-sufficient network of 4,063 outlets that served around 27.0 million savers and 2.8 million borrowers at end-2001.<sup>43</sup>

BDB is one of the oldest private commercial banks offering microfinance on a commercial basis in the world. It was established in 1970 by a husband and wife team of professional moneylenders to serve better the Balinese community of local traders and produce merchants.<sup>44</sup> Although BDB is a relatively small bank, it is important because it has remained dedicated to microfinance and small business lending. While commercially structured, the bank has retained a social objective over the last 30 years by opting to make only moderate profit margins in order to concentrate on prudently increasing its depth of outreach (i.e., reaching lower-income clients).

Numerous other commercially-oriented MFIs exist and many of them have a long history of operation. For example, some of the 4,500 village-owned village credit organizations (*Badan Kredit Desas*, or BKDs) have been providing microfinance at the local level, particularly in rural Java, for more than 100 years. Only slightly younger, the system of more than 2,500 locally-owned BPRs also has a long history of providing commercial microfinance. Indonesian NGOs, unlike their counterparts in most other countries, play a relatively minor role in the microfinance industry, partly because of their repression under the Soeharto regime and because most of them have concentrated on social rather than financial intermediation.

Government and/or donor-supported microcredit or microfinance programs have had a mixed record in supporting the commercialization of microfinance. Since the 1970s, expanding access of the poor to credit has been a major part of the Government's strategy to promote equitable growth and reduce poverty.<sup>45</sup> While a few interventions have facilitated the commercialization of microfinance by following the new "financial systems approach," many microcredit programs based on the old paradigm of subsidized, directed credit have been harmful to the expansion of commercial microfinance.

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 with clear legal status. A few particularly market-friendly government and/or donor-sponsored programs have been, in chronological order, the Rural Income Generation Project (RIGP) supported by the Indonesian Government, 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* (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, USAID, and HIID; the Microcredit

Project implemented by BI with ADB-funded technical assistance since 1996; and the Promotion of Small Financial Institutions (ProFI) project also implemented by BI but with technical assistance support from GTZ from 1999.

Examples of subsidized, directed credit programs that inhibit commercial microlending are unfortunately plentiful. 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% effective annual interest rates and less than a 20% cumulative repayment rate.

There was a move by the Government to give up the subsidized credit approach as ineffectual and wasteful in 1990, when 30 of the 34 major programs were scrapped.<sup>46</sup> However, experiences like the above show that government policy has been highly inconsistent. Worse, it appears that policy reversion to the old paradigm is an increasing danger in light of recent decentralization of government budgets and the regional drive to use a portion of those funds to create new MFIs; increase fund injections, such as the fuel subsidy program (the Cash Subsidy for Gasoline Program; BMM [*Program Dana Tunai Subsidi Bantuan Bakar Minyak*]); and use cheap credit as a tool to attract votes in the 2004 elections.

Unlike other commercial microfinance industries, an individual lending approach has been more prevalent than group lending in Indonesia. The success enjoyed by BRI, as an early market leader, with its individual loan product *Kupedes*, influenced later microcredit product development by other MFIs. The

traditional group lending methodologies usually employed by microfinance NGOs had little relative influence on the market, in line with the unusually small role NGOs have played in Indonesia's microfinance industry. The long-standing focus on individual lending has kept attention on project viability, income streams, and debt capacities, but these have not come at the cost of microfinance service provision to lower-income clientele (e.g., individual lending is employed by most MFIs, serving a wide range of clients including the very poor).

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### EVIDENCE OF UNMET DEMAND

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Demand for microfinance varies between and within regions. Existing demand is arguably only partly met by MFIs and there exists an opportunity to expand outreach. Despite the remarkable outreach that the BRI Units and other highly commercial MFIs have achieved in extending savings and credit services throughout Indonesia, most Indonesians still do not make use of formal banking services. Evidence supporting this is provided by two recent surveys.

As part of an ADB-supported project preparatory technical assistance concluded in 2003, participatory rural appraisals were carried out in 10 selected villages across 5 provinces to assess the demand for financial services. The methodology included focus-group discussions, surveys of 120 rural households (representing an approximately equal mix of nonpoor, poor, and extremely poor) and in-depth interviews with 34 poor, rural households that had microenterprises. Although these surveys were limited to only a few households, they provide at least indicative results concerning access to financial services as well as constraints and opportunities to expand outreach. Almost half of the sampled households did not have a savings account and more than 60% of the respondents had no access to credit from any semiformal or formal financial institution.

An earlier, more comprehensive survey conducted by BRI jointly with Harvard University advisors in late 2000 produced similar

results. The BRI survey had wider household coverage, with 1,426 respondents throughout Indonesia. The design parameters and the sampling process were structured in a way that allowed results from selected respondents to be used to make assumptions about the general population. The results showed that, despite all efforts of financial deepening over the past 3 decades, the majority of villagers still do not have access to formal or semiformal financial services. Some 62% of surveyed households without a viable enterprise did not have savings accounts and 68% did not have credit from any financial institution.<sup>47</sup> In households with a viable enterprise, 52% did not have a savings account and 58% did not have a loan from a financial institution.

However, it is important to recognize that "lack of access to credit" is not necessarily equivalent to "unmet demand for credit."<sup>48</sup> Findings from both surveys were that it is often the villager's own decision not to borrow, for good reasons. During the in-depth interviews conducted as part of the ADB survey, respondents voiced doubts about their own repayment capacity and their resulting unwillingness to pledge any collateral for fear of losing it, especially those involved in agricultural production and subject to substantial price and yield risks. Similarly, in the BRI survey, two thirds of the 68% who did not have credit from any financial institution said that they did not want to have debt. It appears that demand for microsavings is high, while demand for microcredit is considerably lower than commonly assumed.

Ample evidence has shown that low-income households primarily need savings instruments that enable them to manage their liquidity effectively and finance special expenditures. Repeated surveys through the 1980s and 1990s have consistently shown that the rural poor in Indonesia valued safety, liquidity, and convenience more than returns.<sup>49</sup> This is supported by the 2003 ADB survey findings, which indicate that there appears to be a considerable demand for safe, convenient, and easily accessible savings facilities that are geared

to the savings capacity and needs of the poor. Women, in particular, show a considerable demand for these type of services because they often try to build up reserves for school expenses, family health care, or children’s wedding expenses, and often hide them from their husbands.

Microcredit demand based on the two surveys is considerably lower and varies much more than demand for microsavings by location and client type. Clients range from “tiny family businesses characterized by subsistence orientation, low productivity, and high volatility to fast-growing businesses with high potential to graduate to the small enterprise sector.”<sup>50</sup> Microcredit demand is primarily for the expansion of existing businesses and for a variety of off-farm activities. Required loan sizes are Rp1 million–3 million (\$112–336, based on end-2002 exchange rates). Comparing these indicative figures with the cash-flow patterns and level of indebtedness of the interviewed sample, there seems to be sufficient repayment capacity to sustain this loan demand. None of the households interviewed in the 2003 ADB survey indicated an interest in borrowing

from commercial sources for farming activities. In general, agricultural production was considered to be too risky to be financed from borrowings. Households claimed that to obtain agricultural inputs they preferred to rely on savings from previous harvests, supplemented by income from other economic activities.

**TOTAL SUPPLY**

The microfinance sector is currently comprised of a large variety of public and private institutions as well as government and donor-sponsored programs (Table 2.1). This section highlights the various institutions and programs in order of the formality of their structure.

**Formal MFIs**

The largest and most significant players in Indonesia’s microfinance market are formal MFIs that employ a commercial approach to microfinance. These include commercial banks and the system of BPRs, regulated by BI; and

**Table 2.1: Supply of Microfinance by Formality of Provider Type**

| Informal Microfinance Providers<br>(predominant level of service) | Semiformal MFIs<br>(predominant level of service)   | Formal MFIs<br>(predominant level of service)       |
|---|---|---|
| Microfinance NGOs (village)                                       | Rural credit fund institutions (LDKPs) (subdistrict and village)                            | Primary commercial banks (district and subdistrict) |
| Moneylenders (village)  | Village credit institutions (BKDs) (village)  | - State-owned BRI Units<br>- BDB                    |
| Traders (village)   | Microfinance cooperatives (district and subdistrict)  | Secondary banks (subdistrict)                       |
| Savings and credit associations (village)                         | - Savings and credit cooperatives (KSP)<br>- Savings and credit units of cooperatives (USP) | - BPRs  |
| Friends and family (village)                                      | - Savings and credit service points (TPSP) (village)  | State-owned pawnshops (district and subdistrict)    |

Sources: Adapted from Sukarno 1999, p. 6-7; and Holloh 2001, p. 32.

the outlets of a state-owned pawning company (*Perum Pegadaian*, or PP), regulated by the Ministry of State-owned Enterprises. Many banks are involved in the microfinance sector by acting as channels for government credit programs and by cooperating with small financial institutions and cooperatives; however, only a few commercial banks have their own units dedicated to providing microfinance.<sup>51</sup> The only microfinance window of the banking sector with national coverage is the BRI Unit system, although BDB has regional significance.

### Semiformal MFIs

The main semiformal MFIs include a variety of NBFIs, cooperatives, and credit unions that operate at the subdistrict or village level. The two major NBFIs are the BKDs and the Rural Credit

Fund Institutions or *Lembaga Dana Kredit Pedesaan* (LDKPs), which have been established on the initiative of provincial governments since the 1970s and are licensed, regulated, and supervised by the provincial governments. Licensed cooperatives and credit unions are regulated by the Ministry of Cooperatives. The dearth of documentation concerning cooperatives, however, allows only information on the microfinance operations of the LDKPs and BKDs to be used here (see Table 2.2).

### Informal Providers

The main informal suppliers are local organizations, such as microfinance NGOs, which are licensed by the Ministry of Justice and Human Rights<sup>52</sup> but not actively regulated or supervised; savings and credit associations

**Table 2.2: Total Microfinance Supply**

| MFI Name/Type          | Units<br>No.  | O/S Loans         |              | O/S Loans     |              | Total Deposits    |              | Total Deposits |              |  |
|------------------------|---------------|-------------------|--------------|---------------|--------------|-------------------|--------------|----------------|--------------|--|
|                        |               | No.               | %            | Rp billion    | %            | No.               | %            | Rp billion     | %            |  |
| BDB                    | 31            | 9,311             | 0.1          | 57            | 0.3          | 242,146           | 0.7          | 190            | 0.6          |  |
| <b>Formal MFIs</b>     |               |                   |              |               |              |                   |              |                |              |  |
| BRI Units              | 4,063         | 2,790,000         | 23.2         | 9,841         | 43.5         | 27,040,000        | 77.5         | 21,991         | 74.2         |  |
| BPRs                   | 2,143         | 1,900,000         | 15.8         | 6,420         | 28.4         | 5,200,000         | 14.9         | 5,597          | 18.9         |  |
| <i>Perum Pegadaian</i> | 714           | 5,230,743         | 43.4         | 1,355         | 6.0          | –                 | 0.0          | –              | 0.0          |  |
| LDKPs                  | 1,603         | 500,000           | 4.2          | 337           | 1.5          | 871,000           | 2.5          | 342            | 1.2          |  |
| <b>Semiformal MFIs</b> |               |                   |              |               |              |                   |              |                |              |  |
| BKD                    | 4,518         | 658,871           | 5.5          | 198           | 0.9          | 571,744           | 1.6          | 38             | 0.1          |  |
| Cooperatives           |               |                   |              |               |              |                   |              |                |              |  |
| KSPs                   | 1,097         | 655,000           | 5.4          | 531           | 2.3          | 655,000           | 1.9          | 85             | 0.3          |  |
| USPs                   | 35,218        | –                 | 0.0          | 3,629         | 16.0         | –                 | 0.0          | 1,157          | 3.9          |  |
| Credit Unions          | 1,071         | 296,000           | 2.5          | 272           | 1.2          | 296,000           | 0.8          | 249            | 0.8          |  |
| <b>Total</b>           | <b>50,458</b> | <b>12,039,925</b> | <b>100.0</b> | <b>22,640</b> | <b>100.0</b> | <b>34,875,890</b> | <b>100.0</b> | <b>29,648</b>  | <b>100.0</b> |  |

BDB = *Bank Dagang Bali*; BKD = *Badan Kredit Desa*; BPR = *Bank Perkreditan Rakyat*; LDKP = *Lembaga Dana Kredit Pedesaan*; KSP = *Koperasi Simpan Pinjam*; USP = *Unit Simpan Pinjam*.

**BDB:** All figures reflect self-reported data as of end-2001. **BRI Units:** data are as of end-2001 and from BRI (2001, p. 44); units include BRI Units (3,823) and Village Service Posts (PPDs) (240). **BPRs:** data are as at 30 September 2002 from BI (2003). ***Perum Pegadaian*:** data are as of end-2001; units refer to number of branches (BI 2001, p. 147); the total number of outstanding loans is based on 15.7 million customers served in 2001 (with an average loan maturity of 4 months); the total outstanding loan amount is from ADB (2003). **LDKPs:** estimates are for 30 June 2000 for 7 of 8 types of LDKPs as included in Holloh (2001, p. 34). **BKDs:** data are as of 31 July 2002, provided by the BRI Head Office; the number of units equals the active number of BKDs. **Cooperatives:** data are as of 30 April 1999 based on estimates presented in BI 2003 and ADB 2003. **Credit Unions:** data are as of end-2001, from ADB (2003).

(*Koperasi Kredit*); rotating savings and credit clubs (*Arisans*); moneylenders; traders; and friends and family. Due to the lack of information on these informal microcredit or microfinance providers, only the microfinance NGOs are included in this assessment of total microfinance supply.

### Program Microfinance

In addition to the various types of institutional and informal sources of microfinance, several large government and donor-funded microfinance programs exist. These include, among others, the Rural Income Generation Project (RIGP/P4K) of the Ministry of Agriculture and BRI, with funding from the Indonesian Government, ADB, and International Fund for Agricultural Development; the Family Welfare Income Generation Project (UPPKS) implemented by the National Planning Coordination Board (BKKBN), funded mainly out of a revolving fund set up by former President Soeharto; the Subdistrict Development Program (PKK) implemented by BAPPENAS, supported by the Government and World Bank (\$200 million); and the Urban Poverty Alleviation Project (P2KP), also implemented by BAPPENAS and funded in part by the World Bank (\$100 million). Detailed discussion of the major programs, however, appears in Chapters 3 or 5, depending on whether or not they are conducive to increased microfinance commercialization.

### Relative Market Shares of Major Microfinance Suppliers

Table 2.2 shows clearly that formal MFIs dominate the microfinance market in terms of their share of the total outstanding loans and deposits by number and by amount. Interestingly, the market leader in terms of number of microloans is the state-owned pawning company, with 43% of the total outreach. However, the BRI Units enjoy more than 40% of the microcredit market by amount of outstanding loans. More than 90% of the total loans disbursed by the BRI Units in 2001 were less than Rp10 million (\$974) and 75% were less than Rp5 million (\$487). The BRI Units have successfully funded their

microcredit outreach by mobilizing over 70% of the total deposits by number and amount. BPRs have about 30% of the market outreach by number of microloans and about 16% by amount outstanding. BPRs also are the second largest mobilizers of deposits to fund their microcredit outreach.

The low market shares of semiformal MFIs reflect the much smaller, localized nature of their operations and the fact that they do not engage significantly in deposit mobilization. Unfortunately, lack of reliable data on the microfinance operations of cooperatives and credit unions prevents a full comparison of their relative market positions.

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## MAJOR MICROFINANCE INSTITUTIONS

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### Private Commercial Banks

The banking sector is still recovering from the crises of the 1990s; most private commercial banks maintain a conservative lending policy and keep away from microenterprises and poor households, which are generally perceived as higher credit risks than wealthier clients with larger businesses. While a few private commercial banks have begun offering microcredit products in recent years, largely because of the demonstration effect of BRI Units profitability, most of these operations remain small. Many private commercial banks still require traditional forms of collateral, and most microentrepreneurs and poor households, especially the rural poor and women, generally do not have collateral in their name. BDB, however, has overcome these constraints to achieve regional significance in the microfinance market.

By virtue of its private ownership and formal status as a commercial bank, BDB may be considered the most commercial MFI operating in Indonesia. Despite this, the bank has not lost sight of its original mission of serving poor and low-income clients. BDB was established by a husband and wife engaged in microenterprise and moneylending. As their moneylending businesses grew, it became apparent that creating a formal

bank offered the couple the best opportunity to continue to expand their microfinance activities. Over the last 30 years, BDB has accumulated significant expertise in serving microenterprises and small-scale businesses while turning a profit, which amounted to Rp46 billion (\$4.4 million) in 2001.<sup>53</sup>

BDB classifies 70% of its outstanding loan portfolio as microcredit, which is mostly disbursed to rural and urban retailers and small traders on the island of Bali. However, BDB also has had healthy growth in its relatively small microfinance operations in Surabaya and Jakarta. The average outstanding microloan amount is around Rp6 million (\$577), but this represents a wide range of better-off clients borrowing amounts of more than Rp10 million (\$962) mixed with poorer clients who borrow smaller amounts (about 10% of BDB's clients borrow amounts less than Rp4.5 million [\$433]). Around 90% of the bank's clients are repeat customers, indicating strong client loyalty, and about 25% of the borrowers are women. BDB reports a 92.7% on-time loan repayment rate for its total portfolio and a 100% on-time loan collection for its microcredit portfolio. To ensure high loan repayment, BDB requires personal marketable asset collateral or cosigners on the loan. BDB charges a 30–36% annual interest rate (based on a declining balance) on its loans.

Due in large part to BDB's formal status, commercialized operations, and good performance, mobilized deposits fund most of the bank's microlending. The bank's deposit-to-loan ratio exceeds 300% because the current savers far exceed active borrowers. BDB management recognizes that access to safe and liquid savings provides a useful service for their clientele. The average amount saved, nearly Rp800,000 (around \$77), is much lower than the average outstanding loan. In addition to mobilizing deposits as a source of funds, BDB has accessed international financial markets, at least in terms of social investors. For example, the bank signed an agreement in late 2001 to finance microenterprises and small businesses in Indonesia with the Dexia Micro Credit Fund and the Netherlands Development Financial

Company (FMO). BDB's excess liquidity is split about evenly between placements with other banks (interbank call money and certificates of deposits) and holdings of marketable securities. The bank's surplus of funds may largely be due to its regional focus (as opposed to national coverage) and its virtual saturation of the local market of creditworthy potential borrowers who are willing and able to pledge collateral in order to access microloans. Recent tapping of social investors by BDB may be an effort to cover at least some the costs of the bank's expected future expansion beyond the limited areas it currently serves.

### **BRI Units**

BRI houses the world's largest microfinance network in its Micro Business Division, which caters to micro and small-scale entrepreneurs and operates on a commercial basis, despite its public ownership. There are currently 3,823 BRI Units (96% of which are profitable) and 240 village service points, in addition to BRI branches. The Micro Business Division functions as an independent profit center within BRI, and each unit is a profit center within the division. The BRI Units have an extremely efficient management information system that allows management to assess the performance of each unit and apply a sophisticated employee incentive system, which encourages profitability, loan recovery, and savings mobilization. The Micro Business Division freely sets its own loan terms, although transfer prices (discussed below) are set by the parent company. The commercial approach applied by the BRI Units is reflected in their application of cost-recovery lending interest rates and maintenance of an interest rate spread sufficient to cover the high costs of servicing small loans and deposits. The original interest rate was and remains a flat 1.5% per month (although it briefly rose to 2.2% during the 1997–98 Asian financial crisis). The average annual yield obtained on loans has oscillated around 32% in recent years while average annual financial costs have been about 10%, yielding a large margin of 22%.

*Kupedes* loans are provided for working capital or investment purposes to individuals having a productive enterprise or with regular incomes, such as civil servants and employees of local enterprises. Typical borrowers are government employees or pensioners, small traders, and entrepreneurs.<sup>54</sup> Loan amounts are Rp25,000–25 million (\$3–2,683, based on 2002 average exchange rates), but loan applications of less than Rp500,000 (\$54) are now rare. As long as the maximum ceiling is not reached, a borrower can take both working capital and investment loans in parallel. *Kupedes* terms are 3–36 months, with repayment schedules adjusted to match the cash flows of the borrower's enterprise. All loans are monthly installment loans with grace periods of 3–6 months.

With an average disbursed loan size of Rp5.6 million (\$538) and an average outstanding loan size of Rp3.5 million (\$337) as of end-2001, it appears that the BRI Units lend to better-off poor and nonpoor households. As of June 2000, the arrears ratio for all loans one day or more past due was only 3.9%.<sup>55</sup> To minimize default risk, BRI requires individual borrowers to put up collateral, a policy that excludes the poorest borrowers. The collateral required is equivalent to the value of the loan principal and interest to be paid. Loans larger than Rp5 million (\$559, based on end-2002 exchange rate) require a land certificate as collateral. Loans are usually secured with land certificates, motor vehicle ownership certificates, or a pledging of salary or pension. Deposits may be pledged as partial collateral. The client has to sign an acknowledgment of his debt, an authorization for the bank to execute the collateral pledged, and his wife/her husband has to sign a guaranty.<sup>56</sup> The loan principle and interest are secured by life insurance and the 0.75% premium is paid by BRI. Staff have discretion to increase the loan size for reliable borrowers who may not be able to fully collateralize their loans. Loan officers typically start clients off with small loans and condition future larger loans on good repayment.

A special feature of the *Kupedes* loans is the incentive system to promote timely repayments. A refund of 25% of the interest paid is made when

installments are not delayed for six consecutive months. *Kupedes* borrowers have paid back more than 97% of all loans that ever have fallen due.<sup>57</sup> According to BRI, the Units' 12-month loss ratio at the end of 2001 was only 1.5%.

Surveys since 1982 have pointed to extensive rural demand for reliable and liquid deposit facilities.<sup>58</sup> Four savings instruments, with interest rates that vary by account size and liquidity, were made available at the BRI Units starting in 1986, as part of their new rural savings program. The instruments were designed to be appropriate for the target market and BRI Unit deposit growth has been quite rapid. Deposits have exceeded the outstanding loan portfolio since 1989 and the deposit-to-loan ratio has increased every year since. At end-2001, this ratio was 223% of the loan portfolio.<sup>59</sup>

As a profit center, the BRI Units have immediate value for their excess liquidity (total deposits minus total loans and cash required to support saving and loan transactions) by moving excess funds to BRI and benefiting from a transfer price that aims to compensate the BRI Units' financial and operational costs of mobilizing deposits. The transfer price is adjusted periodically according to BRI's overall liquidity position. The transfer price is usually set slightly higher than the top savings rate offered at the Units so that those with a surplus of funds can at least cover their interest costs, and are not discouraged from mobilizing savings.<sup>60</sup> BRI's maintenance of a transfer price higher than the interest rate paid by the Units on savings has prompted them to mobilize deposits actively and this has largely contributed to the phenomenal amount of mostly small deposits mobilized by the Unit system. Prior to the Asian financial crisis, the BRI Unit system reinvested close to 60% of deposits mobilized in their loan portfolios. This ratio has dwindled to about a third since the crisis. This drain of funds out of the Unit system to BRI indicates that the many small savings mobilized by the BRI Units (average size was Rp700,000 or \$67 at end-2001) have been converted into larger loans provided to an urban and more affluent clientele of the bank, rather than to the rural poor.

The BRI Units are not subsidized and have been highly profitable since the mid-1980s. During 1996–1999, the Unit system made profits amounting to Rp2.9 trillion (\$525 million).<sup>61</sup> Prior to the financial crisis, the Units contributed about one quarter of BRI assets and produced annual profits larger than the bank’s total retained profits, thus maintaining positive returns.<sup>62</sup> Despite the high profitability of the BRI Units, their status as a profit center within a state-owned bank puts the system’s profits at risk of being diverted to unprofitable investments and at no time was this made clearer than during the 1997–1998 Asian financial crisis. However, when BRI was affected by the crisis, 56% of its mainly large loan portfolio had to be written off resulting in a loss of \$3.3 billion against a capital base of only \$215 million, leaving the bank technically insolvent. The Government had to step in to recapitalize BRI and the nonperforming loans were transferred to IBRA.

### BPRs

The system of BPRs has a long history and includes a variety of MFIs with different historical backgrounds. The first institutions that would become recognized as BPRs, with a 1988 deregulation package and the 1992 Banking Act, had their start in the early 1900s. Some historical highlights are presented below.<sup>63</sup> The focus here is on the BPR system at present, its level of commercialization, and recent performance.

The BPR industry in general is providing microfinance on a commercial basis through the formal financial system, having predominantly local, private ownership, and funding the provision of microcredit almost wholly from deposits. The system of BPRs is extremely diverse in terms of governance, management, outreach, and financial performance.<sup>64</sup> Nevertheless, the system as a whole has achieved significant outreach, reaching clients in some regions that had no access to banking services before the 1988 banking reforms. At the end of September 2002, there were 2,143 licensed BPRs.<sup>65</sup> With changes in the law and classification of BPRs over time, BPRs are allowed to take several legal forms. At

the end of 2002, 62% were registered as limited liability companies, 35% as regional government enterprises, 3% as cooperatives, and less than 1% as other legal forms.

As of March 2000, about 5% of Indonesian households had loans provided by BPRs and the average BPR had 905 loan accounts, with an average outstanding amount of Rp1.2 million (\$141) each.<sup>66</sup> The average outstanding loan size was Rp3.1 million (\$333) as of June 2002.<sup>67</sup> BPR credit products vary with regard to interest rates and terms. The average annual effective interest rates are 31–44%, which are undoubtedly commercial. Loan maturities averaged 9–26 months. The average annual effective interest paid on the main savings products was 12%, allowing a margin of 19–32%.

Unlike commercial banks, no ownership of BPRs by foreign parties is permitted. This limits the ability of BPRs to attract foreign capital as a source of funds. However, most BPRs have access to mobilized deposits as a source of funds. As of March 2000, the average BPR had 1,882 savings accounts and assuming one account per household, an outreach to about 10% of all households.<sup>68</sup> The average BPR industry savings deposit was Rp0.9 million (\$97) as of June 2002, when total deposits contributed approximately 86% of the total outstanding loan portfolio, although there were significant regional differences between BPRs. In addition to mobilizing deposits as a source of commercial funds, increased disclosure and transparency of BPRs promoted by BI’s BPR Supervision Department is leading to increasing access of BPRs to loans from commercial banks (Box 2.1). An estimated one third of BPRs now have established borrower relationships with commercial banks. For loans in excess of Rp500 million (\$55,928), however, physical collateral is still generally required by commercial banks. The BPR system as a whole has substantial liquidity, but much of this is needed to offset the high, 2:1, ratio of term deposits to savings deposits, to provide a cushion for increased lending, and to offset the lack of an effective inter-BPR funds transfer mechanism.<sup>69</sup>

Several indicators of loan portfolio quality signal that the BPRs generally have fairly

## Box 2.1

**Increased Access of BPRs to Loans from Commercial Banks**

Bank Indonesia's BPR Supervision Department has been facilitating linkages between commercial banks and BPRs over the last few years to enhance BPR eligibility to take up commercial bank loans as a source of funds. To be eligible, BPRs must specify as part of their business plan the loan amount desired and how the funds will be utilized. Once this has been submitted, along with usual financial disclosure and reporting, BI ranks the BPR as sound, fair, or unsound according to CAMEL (Capital, Asset, Management, Equity, and Liquidity) criteria. BI may informally recommend to the 15 commercial banks currently participating that the BPR is financially healthy and represents a good credit risk. BI also provides interested commercial bankers with 2-week training courses on how to evaluate BPRs as prospective borrowers. When a match is made, loans of up to Rp500 million (\$55,928) are lent by the commercial banks without collateral for 1 year rollovers at an annual interest rate around the current prime of 18–20% (declining basis) and re-lent by the BPR at annual interest rates of 24–30%.

Source: Interview with Mr. Santoso Wibowo, Manager of Research and Regulation of BPRs, Bank Supervision Department, BI.

high-risk operations with relatively poor portfolio quality, thereby placing client deposits at some risk. The overall loan portfolio-at-risk ratio<sup>70</sup> was 21% for loans over 90 days past due. BI classified 4% of the industry's total loan portfolio as substandard, 6% as doubtful, and 11% as lost. However, its loan classification system provides high tolerances, i.e., monthly installment loans in arrears for less than 3 months are classified as standard. These loans have to be classified as lost only after 27 months.<sup>71</sup> One third of the BPRs lack clear policies for lending to related parties. General lending limits applied do not prevent concentrating large parts of the loan portfolio in a few hands.<sup>72</sup> More adjustments will be needed

to ensure that BPR performance improves to enable them to play a significant role in the expansion of commercial microfinance.

**Pawnshops**

Pawnshops are an important part of the microfinance sector in Indonesia and have been major providers of commercial microcredit for some time. The first pawnshops were established in the beginning of the 20<sup>th</sup> century. For many years, pawning was a monopoly of the Government and from 1990 it was organized in the form of a profit-oriented state enterprise, PP. The company has grown in professionalism and developed into a service-oriented institution that provides low-income households, who hold their savings in movable assets, with an important source of liquidity.<sup>73</sup> While regulated and supervised for many years by the Ministry of Finance, the company is now regulated and supervised by the Ministry of State-owned Enterprises.

The Government liberalized the pawning business in 2002, ending PP's monopoly and allowing banks or private firms to act as pawnbrokers. Already, two major commercial banks—Mandiri and BRI—have set up their own pawn operations based on the Sharia model.<sup>74</sup> A number of private companies have also set up shop in major Indonesian cities, focusing on attracting middle- and upper-class clients. However, these newer operations remain quite small relative to PP's pawning business.

Between 1990 and 2001,<sup>75</sup> PP's offices increased in number from 505 to 714 and are now in every district capital and increasingly in subdistrict capitals. PP offers efficient services: they are open 6 days each week, provide simple and fast transactions—usually 15 minutes or less—and allow customers to turn their valuables (gold, jewelry, household items, electronic goods, motor vehicles, and recently even unhulled paddy, valuable fabrics, and hand-woven cloth) into cash without having to sell them. Borrower transaction costs are minimal. Administrative expenses on average loans outstanding are about 20.75%.<sup>76</sup> Loans can range from Rp5,000 (\$0.56) to more than Rp20 million (\$2,237). Smaller loans

carry lower interest rates, a flat 1.25% per month for loans up to Rp150,000 (\$17) to 1.75% per month for loans in excess of Rp500,000 (\$56). Standard maturity is 120 days. Additionally, the company charges insurance costs and a deposit fee on all loans.

The decline in financial intermediation by banks because of the Asian financial crisis contributed to the sharp growth of PP. Between the end of 1996 and the end of 1999, the company's assets increased from Rp647 billion (\$88.2 million) to Rp1,151 billion (\$162.1 million), its amount of loans outstanding from Rp414 billion (\$56.5 million) to Rp705 billion (\$99.3 million), and its net profit from Rp34 billion (\$4.6 million) to Rp61 billion (\$8.6 million).<sup>77</sup>

In 2001, the company provided 22.2 million loans to 15.7 million borrowers. Its loans are small in size. As Table 2.3 shows, about 88% of PP loans in 2001 were less than Rp500,000 (roughly less than \$60).<sup>78</sup> Also, the items accepted/pawned indicate that PP indeed serves microcredit clients ranging from very poor to low-income. Box 2.2 describes a typical low-income borrower. About 35% of PP clients are farmers, fishers, and small-scale entrepreneurs. During 2001, it disbursed Rp5,970 billion (about \$702 million) and at the end of 2001 had an outstanding loan portfolio of Rp1,355 billion (\$159 million). Its loan recovery rates are high. Collateral is sold when borrowers default, although it has only had to auction 0.5% of all pawned goods to date. Its return on assets and return on equity in 2001 were 4.5% and 17.0%, respectively. Together these indicators all point to a successful, commercial enterprise, despite its public ownership.

PP's sources of funding are mixed between commercial and subsidized sources. To raise working capital, PP issues bonds and notes, a favorite on the corporate bond market and one of the most highly traded on the local secondary market. However, during the Asian financial crisis, it also resorted to borrowing from the Government as well as taking BI liquidity credits to meet the greatly increased public demand for loans. PP recently received new soft loans from

**Table 2.3: Distribution of *Perum Pegadaian* Loans by Size, 2001**

| Loan Size (\$ Equivalent) | Number of Loans (million) | %          |
|---------------------------|---------------------------|------------|
| 1.1 - 4.5                 | 8.6                       | 39         |
| 4.5 - 16.7                | 5.4                       | 24         |
| 16.7 - 55.5               | 5.6                       | 25         |
| >55.5                     | 2.6                       | 12         |
| <b>Total</b>              | <b>22.2</b>               | <b>100</b> |

Notes: Data are as of end-2001; the total number of outstanding loans is based on 15.7 million customers served in 2001 (with an average loan maturity of 4 months; note that 5.2 million loans were outstanding at the end of the year, shown in Table 2.2); the total outstanding loan amount is from ADB (2003).

Source: Fernando 2003, p. 4.

Box 2.2

**Expanding Access to Microcredit through Pawning**

When Ms. Sumarni, a maid working in Jakarta, needed Rp300,000 (\$34) to help her brother fix his motorcycle last year, she went to a pawnshop, and took out a short-term loan using an FM radio set and some gold jewelry as collateral.

She had 4 months in which to pay back the loan plus 3% monthly interest, and to redeem her items, but she spent most of her next salary to do so.

"The pawnshop suited my purpose. Borrowing from my employer was possible, but I didn't want to do that. A private moneylender would have charged higher interests, while banks would have been too complicated and taken too long.

I paid quickly to avoid the interest charges and to make sure my collateral didn't get auctioned off by accident," Ms. Sumarni explained.

Source: Go 2002.

the Government in order to expand its operations. Dedy Kusdedi, President Director of PP, told Reuters in an interview on 5 February 2003 that the firm had recently secured Rp1.5 trillion (\$167.8 million) in soft loans from the Government. While PP will obviously use the cheaper funds as long as they are available, it has grander intentions of listing in the stock market to attain additional financing and expand its operations.

### LDKPs

The LPD (*Lembana Perkreditan Desa*) system of LDKPs is the most successful and the only viable system of village-level financial institutions in Indonesia. LDKP is a general term used to describe a variety of regional nonbank MFIs established by provincial and district governments, mainly during the 1970s–1990s. In 1992, the LDKPs were mandated to upgrade to BPR status by October 1997 (by the Banking Act of 1992 and Government Decree No. 71 of 1992). Since the 1997 deadline, the remaining LDKPs have not been allowed to mobilize deposits. According to the monthly financial statistics of BI, the total number of LDKPs stayed essentially the same between the late 1980s (1,936) and the end of 1996 (1,978) and then decreased to 1,603 by June 2000 because of the conversion of about one quarter of them to BPRs.<sup>79</sup> Currently, the Balinese LPDs make up more than half of the remaining active institutions and they operate with 77% of the system's total assets and 85% of the total deposits. The second largest system of LDKPs is the Subdistrict Credit Boards (BKKs) with 14% of the system's total assets.<sup>80</sup>

Although LDKPs are licensed, regulated, and supervised by the provincial governments, technical assistance and supervision are usually delegated to the regional development banks (BPDs), which are also owned by the provincial governments.<sup>81</sup> Although the BPDs can require reporting by LDKPs, such reports are not forwarded to BI and BI has no jurisdiction to require such reporting. The BPDs also deliver technical guidance to LDKPs, but the quality of

this assistance and supervision is reported to vary greatly from province to province, just as the quality of BPDs varies. Because there is no system providing reliable LDKP data at the national level, the focus here is on the remaining LDKPs in Bali (the LPDs), which account for most of the LDKP operations. They are the most commercially-oriented LDKPs and have the most reliable data on their solid performance.

LPDs began in Bali in 1985 and their numbers had grown to 912 by June 2000. There has been high and sustained government commitment to establish an enabling framework for the development of self-reliant and sustainable financial institutions under the ownership of the Balinese *Desa Adat*.<sup>82</sup> The Government of Bali is responsible for regulating and supervising the LPD industry within the framework of national regulations. National banking regulations have been requiring LDKPs to convert to BPRs, but the Balinese Government has been resisting such conversion and continues to demand a national regulatory framework that provides greater flexibility for nonbank MFIs.

BI allows LPDs to mobilize funds from members of the *Desa Adat* provided the LPDs refrain from using banking terminology. This compromise provided LPDs with flexibility to accept deposits, but did not resolve the issue of their legal status in the financial sector. LPDs offer savings deposits, time deposits, and credit services with varying terms. The LPDs have had great success, in part because of their ownership by individual, leading community members and the trust they inspire. The entire loan portfolio and more than three quarters of the total assets of the LPD industry are financed through voluntary savings. The majority of LPDs collect compulsory savings as a percentage of the loan amount disbursed. However, these compulsory savings seldom contribute more than 10% of total funds mobilized.<sup>83</sup> The proficiency of the LPDs at mobilizing deposits also enables them to have large outreach. LPDs provide microfinance in two thirds of the *Desa Adat* and to one third of all Balinese households.

Most loans are provided by LDPs for productive purposes, based on character and membership. Most loans have monthly installments but have a high variance with regard to both terms (10–36 months) and interest rates (2% declining to 3% flat per month). As of March 2000, savings deposits made up 44% of the total liabilities and equity of the LPD industry and they presently offer annual effective interest rates of 10–12%, commensurate with those offered by commercial banks. The average outstanding loan size is around Rp860,000 (\$89) and the average savings account is Rp200,000 (\$21).

According to the ratios and calculation methods applied by the LPD supervision system, the LPD industry is highly profitable. However, a ProFI survey showed that average return on assets (1999) decreased from 8.6% to about 4% for a sample of 81 LPDs (of 912 total) when full loan loss provision costs were included in adjusted income statements (not including adjustments for inflation). Without taking into account full loan provision and inflation costs, the LPD industry had a return on assets of only 2.4% (based on aggregated data) in the first quarter of 2000.<sup>84</sup>

## BKDs

The *Badan Kredit Desa* (BKDs) operate in Java and are village-level financial institutions with historical roots dating back to colonial times. The evolution of banking laws and regulations has resulted in a contradictory situation in which BKDs were acknowledged as BPRs by the letter of the law but are neither regulated nor supervised as secondary banks in practice. BKDs are tiny institutions, often described as profitable and sustainable, providing demand-oriented financial services with a significant outreach to low-income groups.<sup>85</sup> However, several statistics show that while a few individual institutions might perform well and play a significant role in the village economy, BKDs as a whole are far from commercial in their approach to microfinance and their general performance is poor.

According to BRI statistics, there were 4,566 operational BKDs as of June 2000. They currently

reach less than 3% of the total number of households in Java. BKDs are usually described as village-owned financial institutions. However, there is a distinction between village-level institutions owned and controlled by the village community and those owned and controlled by the village government.<sup>86</sup> The LPDs in Bali are examples of the first type while BKDs fall into the second category in that they are managed and controlled by the village bureaucracy. Weak ownership and governance combined with poor banking skills and lack of effective internal control have contributed to low levels of outreach and financial sustainability. Based on unadjusted financial statements, profits made during the first half of 2000 were equivalent to 39% of total income and almost 4% of average assets during the period. However, taking loan portfolio quality and full loan loss provisions into account there are negative net margins,<sup>87</sup> ranging from -6% in East Java to -22% in West Java, with an average of -8.5% for the entire BKD industry.

By virtue of being registered with the Ministry of Finance, BKDs are subject to regulation/supervision by BI, but historically they have been under the field supervision of BRI officers. BRI continues to supervise the BKDs on behalf of BI and is reimbursed for this service. The supervision system applied by BRI to the BKDs is stricter, at least in terms of measuring loan portfolio quality, than the CAMEL standards applied by BI to banks.<sup>88</sup> Loans without late payment of installment, interest, and compulsory savings are classified as “standard.” Loans with late payments that have fallen due for up to 6 months are classified as “doubtful.” Loans with late payments that have fallen due for longer than 6 months are classified as “lost.” However, BRI is constrained in its role as delegated supervisor because it has no enforcement powers. In addition, the stricter loan classifications are not used in determining credit risk exposure and loan loss provisions. This practice is highly problematic because most BKDs avoid writing off loans and do not fully account for loan loss provision costs in their income statements.<sup>89</sup>

As of June 2000, BKDs were suffering from extremely poor loan portfolio quality. Only 39%

of all loans outstanding and 59% of the total value of the loan portfolio were classified as standard; 37% of all loans and 20% of the loan portfolio were classified as lost. Even if the BI standards were used, with a classified-to-performing-assets ratio of more than 19% on average, the BKD industry would be rated unsound. In addition, with an overall loan loss reserve ratio of only 8% on average, the BKD industry reflects unprudential banking practices.<sup>90</sup>

BKD's are open for business only on certain days, depending on demand and operating capacity issues. While some may be open twice a week, others are open twice a month, and a few are open only once a month. Loan sizes are Rp100,000–1 million (\$11–112) and disbursements are usually made no more than a week or two after application. Interest rate charges to clients are 2–6% flat monthly and the most common interest rate applied is 3% flat per month.<sup>91</sup>

Although the high interest rates charged by BKD's can be considered commercial, BKD's lack sufficient business orientation and commercial operational efficiency to expand in any significant way, despite their provision of microfinance only on a part-time basis. Average loan size has remained stable in recent years at Rp300,000–400,000 (\$34–45); large loans are usually required by farmers for seasonal loans while petty traders with a fast turnover borrow small amounts with weekly installments. These amounts are generally lower than those of other small financial institutions and of some poverty-oriented microfinance programs. However, the low average loan sizes may reflect low levels of capitalization and savings mobilization that restrict the ability of BKD's to meet their customers' credit demand rather than a focus on particularly poor clients.<sup>92</sup> BKD's are not legally authorized to mobilize voluntary savings and most BKD's concern themselves solely with accepting compulsory deposits as prerequisites to loan funds. As of June 2000, total savings made up only 10% of total assets and 87% of these savings were compulsory, collected as a percentage (10%) of the loan disbursed.

## Cooperatives and Credit Unions

The cooperative sector has been characterized by the dualism of semiformal cooperatives and a variety of informal organizations that work according to cooperative principles but have refrained from adopting the legal status of cooperatives. Microfinance cooperatives here are defined as cooperatives that provide microfinance services and are licensed, regulated, and supervised by the Ministry of Cooperatives. Cooperatives specializing in financial services are known as *Koperasi Simpan Pinjam* (KSPs) or savings and credit<sup>93</sup> cooperatives. Multipurpose cooperatives<sup>93</sup> are allowed to provide microfinance if they operate an organizationally differentiated savings and credit unit or *Unit Simpan Pinjam* (USP).

Government intervention in the development of cooperatives was legitimized by Article 33 of the 1945 constitution, which stipulated that the economy has to be organized according to cooperative and family principles.<sup>94</sup> During the "guided economy" (1957–1966) era, cooperatives were used for channeling inputs and credit to farms. Despite the widespread corruption and high losses incurred by subsidized credit programs that continued to be channeled through the cooperatives during the 1980s and 1990s, the cooperative sector has been exempt from the series of market-oriented reforms implemented since the late 1980s. Even while financial sector reforms during this time reduced existing distortions, new ones were added by reinforcing the protection and subsidization of cooperatives.

The cooperative sector is presently regulated by Government Regulation No. 9 of 1995 and Ministerial Decree No. 351 of 1998.<sup>94</sup> The regulation stipulates that savings and credit activities may only be carried out by KSPs and USPs that are separated from other business units of primary or secondary multipurpose cooperatives.<sup>96</sup> It also provides for the Ministry of Cooperatives to provide "guidance" rather than supervision to KSPs/USPs; carry out inspections; and provide advice regarding capitalization, changes of management, and

liquidation when problems cannot be resolved. The Ministerial Decree was aimed at motivating the establishment of new KSPs/USPs and improving the performance of the industry. The establishment of new KSPs/USPs and branches requires a paid-up capital of Rp15 million (\$1,678) for primary cooperatives and Rp50 million (\$5,593) for secondary cooperatives, although the decree also states that KSPs/USPs that have not yet fulfilled the capital requirements will nevertheless be legalized, but must limit financial services to members.<sup>97</sup> Fully capitalized cooperatives may provide financial services to members, member candidates, and other cooperatives and their members.

More detailed provisions on the contents of required finance reports as well as the functions and organization of supervision followed in more recent decrees in 1998 and 1999. However, lack of enforcement by the Ministry of Cooperatives has rendered regulation and supervision ineffective. Lack of supervision and unreliable reporting are fundamental weaknesses of the system and no dependable data exist on the licensed cooperative sector as a whole. The reporting system of the Ministry does not allow identification of cooperatives that provide financial services let alone data on their financial operations.

Almost daily news of mismanagement and corruption plague the cooperative sector and the resulting lack of trust has made deposit mobilization virtually impossible. Cooperatives remain extremely dependent on outside funds and many are involved with channeling subsidized credit. Nevertheless, there is a range of member-owned cooperatives that have independently grown in a “grassroots” manner, through strong participation by their members and reliance on their own resources. One example, from West Nusa Tenggara, is *Koperasi Karya Terpadu*, highlighted in Box 2.3. Another is the credit union movement discussed below. There is also a successful microfinance cooperation model called *Swamitra*, discussed in Chapter 3 on institutions and programs that are enabling the expansion of commercial microfinance.

Box 2.3

**Development of the *Koperasi Karya Terpadu* Cooperative**

Located in East Lombok, this cooperative emerged from 13 womens' groups participating in the P4K Rural Income Generation Project, a microfinance and poverty alleviation project implemented by the Ministry of Agriculture and BRI. It is part of a multipurpose cooperative (*Koperasi Serba Usaha*) that focuses on financial services as its main business but also runs a small shop with basic goods, and provides social funds for medical purposes and in the cases of birth, marriage, and death. As of June 2000, the cooperative had organized 42 small groups with 501 members. Its assets, amounting to Rp51 million, were larger than those of many cooperatives with wealthier members and subsidized by government funds.

With its private ownership, reliance on own resources, and businesslike approach to providing microfinance, this cooperative is one example of a successful commercially-oriented MFI, created out of the RIGP/P4K project and continuing to be well managed.

Source: Adapted from Holloh 2001, p. 169.

Credit unions or *Koperasi Kredit* do not differ in terms of organization and operations from savings and credit cooperatives. Until recently, however, they usually operated as informal savings and credit groups because of the heavy government involvement in the cooperative system. Since the liberalization of cooperative regulations, an increasing number of credit unions and their secondary structures have adopted the legal status of savings and credit cooperatives.<sup>98</sup>

Credit unions have been promoted by a national NGO established in 1970, now called the Credit Union Coordination Board of Indonesia (*Badan Koordinasi Koperasi Kredit Indonesia*, BK3I). BK3I established in 1998 a national secondary cooperative for its registered savings and credit cooperatives after having been prevented from doing so for many years.

Presently, the movement has 28 regional chapters of which 16 have already adopted the status of secondary cooperatives. At the primary level, there are 1,105 credit unions.

Despite the financial crisis, the credit unions' total savings and credit grew by about 35% in both 1998 and 1999. Contrary to the vast majority of other types of cooperatives, credit unions have been emphasizing deposit mobilization and reliance on their own resources.<sup>99</sup> Deposits overall represent about 63% of their total liabilities and equity. With reserves and profits equivalent to 16% of total assets, the credit unions appear to be generally sound. Return on assets decreased from 13% in 1998 to 10% in 1999, but remained at a remarkably high level.

### NGOs

Contrary to the situation in other countries, NGOs have not played a leading role in microfinance in Indonesia. NGOs have traditionally been involved with providing training and other social services—social intermediation rather than financial intermediation. NGOs have mostly concentrated their efforts on promotion of self-help groups and many NGOs have focused on the development of savings and credit groups. However, early efforts on the part of a few NGOs to formalize their microfinance operations deserve note because they may be among the world's earliest experiences in the establishment by NGOs of formal financial intermediaries. Although Indonesian NGOs are forbidden to mobilize savings of members unless these are deposited in a regulated financial institution, a few NGOs 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. In total, the NGO has established four BPRs over the last decade. The latter have a mission that

balances a social orientation with a commercial approach and commercialized operations (Box 2.4). Because of the 1995 Company Law No. 1, which states that limited liability companies (the most popular form of BPRs) need to be established by at least two parties, all BPRs established by *Bina Swadaya* have equity shares split between the NGO and its staff association with ratios ranging from 90:10 to 50:50.

In one case, an NGO (*Yayasan Purba Danarta*, located in Semarang, Central Java) even managed to establish in 1990 a locally-operated commercial bank—*Bank Purba Danarta*. 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. LP2SD aims to develop financial self-help groups into formal savings and credit cooperatives and sees the development of independent secondary structures (associations or cooperatives) of these groups as a crucial element in sustaining financial services to low-income groups. However, apart from the few NGOs that have established semiformal or formal MFIs, the vast majority of microfinance NGOs consists of small and unsustainable organizations, dependent on recurrent injections of donor funds to survive.

Box 2.4

#### Mission Statement of the *Bina Swadaya* BPRs

"The mission is to develop loving and bankable people, to give appropriate profit to stakeholders, to improve performance-based remuneration to its workers, to develop regional autonomy, and to develop self-reliance and sustainability."

Source: *Bina Swadaya*.

# 3 Conduciveness of the Operating Environment

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

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## ENABLING POLICIES

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

High-level political support was needed for these banking sector reforms and for the 1983/84 transformation of the institution that has

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

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## APPROPRIATE LEGAL AND REGULATORY FRAMEWORK

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### Tiered Licensing and Regulation

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

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

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

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

Other special regulations offer provisions for fit and proper tests, credit restructuring, short-term financing, and bond portfolio trading. A set of BI decrees, such as for loan loss provisioning,

minimum capital requirements, assessment of asset quality, lending limits, and financial reporting, was implemented to improve prudential banking practices in accordance with international standards. Compliance-based supervision was complemented with risk-based supervision in accordance with international standards.<sup>105</sup> BI's efforts to improve the effectiveness of bank supervision are reflected in the fact that the Senior Deputy Governor was appointed to oversee and coordinate the bank's supervision function.

### **Support for Sharia Banking**

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

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

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

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

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

### **Strengthening BI and Improving Bank Supervision**

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

Since 1998, the Government has been endeavoring to significantly strengthen BI, enhance prudential regulation and supervision of the banking sector, and improve the legal and regulatory framework for microfinance. Banking

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

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

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

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

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#### EXISTENCE OF KEY SUPPORT INSTITUTIONS

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

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

microfinance as a tool for poverty reduction and economic growth. The declaration of GEMA PKM demands substantial changes in economic development strategies and the recognition of microfinance as a mainstream development sector.

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

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

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

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

development of autonomous and self-reliant cooperatives. Training, insurance, interlending, and supervision are the major tasks carried out by the secondary structures of the movement (i.e., 16 of the 28 regional chapters established by BK3I that have adopted the status of secondary cooperatives). As of end-1999, 89% of the cooperatives were participating in the

movement's interlending system and 57% of them were participating in its credit insurance program. Cooperatives receive training through their BK3I regional chapter with courses for beginners, advanced staff, and managers. The credit unions have to pay part of the training costs, while another part is subsidized from income of the secondary cooperatives and from donations.<sup>111</sup>

# 4 Implications of Microfinance Commercialization

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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.

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## COMMERCIALIZATION HAS ALLOWED LARGE-SCALE, SUSTAINABLE OUTREACH

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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 2002<sup>112</sup> 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.<sup>113</sup> 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.<sup>114</sup> 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).<sup>115</sup>

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<br>Outstanding Loan<br>(\$ Equivalent) | % of GDP per<br>Capita |
|------------------------------------|--|------------------------|
| BRI Units                          | 337  | 49.9                   |
| BPRs                               | 333  | 49.0                   |
| <i>Perum Pegadaian</i>             | 42   | 0.1                    |
| MBB Average,<br>MFIs Worldwide     | 453  | 66.6                   |
| MBB Average,<br>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.”<sup>116</sup> 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.”<sup>117</sup>

### 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.<sup>118</sup> 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.

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**COMMERCIALIZATION HAS NOT YET  
YIELDED COMPETITION**

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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.<sup>119</sup>

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.”<sup>120</sup>

# 5 Microfinance Commercialization Challenges

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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.

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## CONSTRAINTS IN THE OPERATING ENVIRONMENT

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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 report<sup>121</sup> 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.<sup>122</sup>

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.

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.

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.<sup>123</sup> 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

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

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

area,<sup>124</sup> 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.<sup>125</sup>

### **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.<sup>126</sup>

### **Gaps and Deficiencies in Cooperative Law**<sup>127</sup>

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.<sup>128</sup> 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.

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## INTERNAL CONSTRAINTS

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### 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.”<sup>129</sup> 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.<sup>130</sup>

As of November 2000, Rp17.6 trillion (\$2.1 billion) of BRI's bad debts transferred to IBRA were outstanding to only 168 borrowers.<sup>131</sup> 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."<sup>132</sup> 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."<sup>133</sup>

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.<sup>134</sup>

### *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.<sup>135</sup>

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).<sup>136</sup>

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.<sup>137</sup>

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

| <b>Economic Sector</b> | <b>Number of Loans Outstanding</b> | <b>Share (%)</b> | <b>Loan Amount (\$ million)</b> | <b>Share (%)</b> |
|------------------------|------------------------------------|------------------|---------------------------------|------------------|
| 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              |
| <b>Total</b>           | <b>2,715,608</b>                   | <b>100.0</b>     | <b>815.8</b>                    | <b>100.0</b>     |

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.<sup>138</sup> 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.<sup>139</sup>

### **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).<sup>140</sup> 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.<sup>141</sup>

### **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,<sup>142</sup> and the systems required for small banks.

# 6 Positive Approaches to Microfinance Commercialization

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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.

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## ROLES OF THE GOVERNMENT

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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

**Table 6.1: Top 10 Priorities for Moving Microfinance Commercialization Forward**

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- 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
- 

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.

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## **ROLES OF FUNDING AGENCIES**

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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.

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### **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.

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### **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.

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# Annexes

## ANNEX 1: SOCIAL INDICATORS

| Item   | 1985  |           | 1990  |           | Latest Year(s)               |
|--|-------|-----------|-------|-----------|------------------------------|
| <b>Population Indicators</b>                                   |       |           |       |           |                              |
| Total Population (million)                                     | 164.6 |           | 179.4 |           | 213.5 (2001) <sup>a</sup>    |
| Population Growth Rate (% change)                              | 2.2   |           | 2.0   |           | 1.4 (1995–2000) <sup>b</sup> |
| <b>Social Indicators</b>                                       |       |           |       |           |                              |
| Total Fertility Rate (births per woman)                        | 4.1   | (1980–85) | 3.3   | (1985–90) | 2.6 (1995–2000) <sup>b</sup> |
| Maternal Mortality Rate<br>(no. per 100,000 live births)       | 360   | (1984–88) | 390   | (1989–94) | 380 (1985–99) <sup>b</sup>   |
| Infant Mortality Rate<br>(below 1 year; per 1,000 live births) | 71    | (1986)    | 71    |           | 30 (2000) <sup>b</sup>       |
| Life Expectancy at Birth (years)                               | 61    | (1983)    | 60    |           | 66 (1998)                    |
| Female   |       |           | 62    |           | 68 (1998)                    |
| Male   |       |           | 58    |           | 64 (1998)                    |
| Adult Literacy (% of people aged 15+)                          | 71    | (1980)    | 84    |           | 87 (2000) <sup>b</sup>       |
| Primary School Enrollment<br>(% of school-age population)      |       |           |       |           |                              |
| Female   | 92    | (1980)    | 79    |           | 83 (1998)                    |
| Male   | 81    | (1980)    | 90    |           | 93 (1998)                    |
| Secondary School Enrollment<br>(% of school-age population)    |       |           |       |           |                              |
| Female   | 53    | (1980)    | 79    |           | 87 (1996)                    |
| Child Malnutrition (% of under age 5)                          | 14    | (1986)    | 12    | (1989)    | 10 (1992)                    |
| Population below Poverty Line (%)                              | 21.6  | (1984)    | 15.1  |           | 18.2 (1999) <sup>c</sup>     |
| Income Ratio of Highest 20% to Lowest 20%                      | 5.2   | (1984)    | 4.7   |           | 4.7 (1999) <sup>c</sup>      |
| Population with Access to Safe Water (%)                       | 38    |           | 63    | (1992)    | 76 (2000) <sup>b</sup>       |
| Population with Access to Safe Sanitation (%)                  |       |           | 51    | (1992)    | 66 (2000) <sup>b</sup>       |
| Public Education Expenditure as % of GDP                       | 1.5   |           | 1.0   |           | 0.8 (1995)                   |
| Public Health Expenditure as % of GDP                          |       |           | 0.6   |           | 0.8 (1999) <sup>b</sup>      |
| Human Development Index  | 0.591 | (1987)    | 0.515 |           | 0.684 (2000) <sup>b</sup>    |
| Human Development Ranking                                      | 77    |           | 108   |           | 110 (2000) <sup>b</sup>      |

<sup>a</sup> ADB 2002a, p.19.

<sup>b</sup> UNDP 2002.

<sup>c</sup> ADB 2001, p. 57.

Source: ADB 2000b, p. 29, unless otherwise noted.

ANNEX 2: ECONOMIC INDICATORS

| Item   | 1997    | 1998    | 1999      | 2000      | 2001      |
|--|---------|---------|-----------|-----------|-----------|
| <b>Output and Growth</b>                     |         |         |           |           |           |
| GDP Growth (% , constant 1993 prices)        | 4.7     | (13.1)  | 0.9       | 4.8       | 3.3       |
| Agriculture                                  | 1.0     | (1.3)   | 2.7       | 1.1       | 0.7       |
| Industry                                     | 5.3     | (11.4)  | 3.8       | 6.2       | 3.0       |
| Services                                     | 3.6     | (3.9)   | 1.9       | 4.0       | 4.5       |
| <b>Savings and Investment</b>                |         |         |           |           |           |
| <b>(at current market prices, % of GDP)</b>  |         |         |           |           |           |
| Gross National Saving                        | 28.7    | 21.6    | 21.2      | 35.6      | 19.8      |
| Gross Domestic Investment                    | 33.0    | 21.0    | 17.6      | 30.3      | 16.0      |
| <b>Government Finance (end of period)</b>    |         |         |           |           |           |
| Revenue and Grants (Rp trillion)             | 93.7    | 120.0   | 152.4     | 204.9     | 299.7     |
| Expenditure (Rp trillion)                    | 92.8    | 129.1   | 185.9     | 220.9     | 334.0     |
| Overall Surplus/Deficit (-)                  | 0.8     | (9.0)   | (33.5)    | (16.0)    | (34.3)    |
| <b>Balance of Payments</b>                   |         |         |           |           |           |
| Merchandise Trade Balance (% of GDP)         | 4.6     | 18.9    | 14.6      | 15.7      | 14.2      |
| Current Account Balance (% of GDP)           | (2.3)   | 4.2     | 4.1       | 5.0       | 3.1       |
| Exports Growth (annual % change)             | 7.3     | (10.5)  | 1.7       | 27.6      | (9.8)     |
| Imports Growth (annual % change)             | 4.5     | (30.9)  | (4.2)     | 31.9      | (12.2)    |
| <b>Money and Inflation (annual % change)</b> |         |         |           |           |           |
| Money Supply (M2)                            | 23.2    | 62.3    | 11.9      | 15.6      | 13.0      |
| Consumer Price Index (end of period)         | 10.3    | 77.6    | 1.9       | 9.3       | 12.5      |
| <b>External Payments Indicators</b>          |         |         |           |           |           |
| Gross Official Reserves (\$ million)         | 21,418  | 23,762  | 27,054    | 29,394    | 28,957    |
| Average Exchange Rate (Rp/\$)                | 8,685   | 7,590   | 9,595     | 9,350     | 10,288    |
| GDP (current prices, Rp billion)             | 627,695 | 955,754 | 1,109,980 | 1,290,684 | 1,490,974 |

Source: ADB 2002b.

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## ENDNOTES

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- <sup>1</sup> This country study adopts Asian Development Bank's definition of microfinance provided in its 2000 Microfinance Development Strategy, "Microfinance is the provision of a broad range of financial services such as deposits, loans, payments services, money transfers, and insurance to the poor and low-income households and their microenterprises" (ADB 2000a, p.25).
- <sup>2</sup> An MFI is defined herein as a single organization (for example, a nongovernment organization providing microfinance) or a unit whose primary business is microfinance within a diversified institution (for example, a microfinance unit within a commercial bank).
- <sup>3</sup> Following Sharia principles, Islamic banking practices replace the lender-borrower relationship in the conventional banking approach with equity and risk sharing between a capital provider and an entrepreneur.
- <sup>4</sup> This area in the decree is referred to as JABOTABEK, or the greater Jakarta area including Jakarta, Bogor, Tangerang, and Bekasi.
- <sup>5</sup> Holloh 2001, p. 84.
- <sup>6</sup> ADB 2003, p. 6.
- <sup>7</sup> The name of this ministry is usually shortened, as in the remainder of this text, to Ministry of Cooperatives.
- <sup>8</sup> BI 2001, p. 149.
- <sup>9</sup> Prins 2000.
- <sup>10</sup> Holloh 2001, p. 106–107.
- <sup>11</sup> Ibid., p. 150–151.
- <sup>12</sup> The financial systems approach to microfinance considers microfinance as part of a country's general financial services market, focuses on the development of sustainable (subsidy-free) financial institutions, and recognizes that microfinance clients are willing to pay the full cost of these services if the services are designed and delivered according to clients' specific needs (Von Pischke 1988; Otero and Rhyne 1994).
- <sup>13</sup> Microfinance practitioner and client group meetings were held throughout the provinces of Central Java, East Java, West Nusa Tenggara, and West Kalimantan.
- <sup>14</sup> See, for example, Poyo and Young 1999; Christen 2000.
- <sup>15</sup> "*Formal institutions* are defined as those that are subject not only to general laws and regulations, but also to banking regulation and supervision. *Semiformal institutions*, are those that are formal in the sense of being registered entities subject to all relevant general laws, including commercial laws, but informal insofar as they are, with few exceptions, not under banking regulation and supervision. *Informal providers* (generally not referred to as institutions), are those to which neither special banking law nor general commercial law applies, and whose operations are such that disputes arising from contact with them, often cannot be settled by recourse to the legal system" (Ledgerwood 1999, p. 12–13).
- <sup>16</sup> Internationale Projekt Consult GmbH (IPC) 2002.
- <sup>17</sup> Fleisig 1996, p. 45; Lyman 2000, p. 39–41.
- <sup>18</sup> ADB 2002b.

- <sup>19</sup> McGuire, Conroy, and Thapa 1998, p. 143–145.
- <sup>20</sup> UNDP 2002.
- <sup>21</sup> ADB 2000b, p. 4.
- <sup>22</sup> During the Asian financial crisis, the exchange rate of the Indonesian rupiah to the US dollar varied dramatically, from a pre-crisis level of Rp2,200 to a peak of Rp16,000 in January 1998. The exchange rate only stabilized in 1999, so only rupiah rates for 2000 and 2001 have been converted to dollars.
- <sup>23</sup> World Bank 2001, p. 7.
- <sup>24</sup> ADB 2001, p. 58–59.
- <sup>25</sup> ADB 2001.
- <sup>26</sup> Sukarno 1999, p. 4.
- <sup>27</sup> Campion and White 1999, p. 14; Robinson 2001, p. xxv).
- <sup>28</sup> BI 2001, p. 5.
- <sup>29</sup> ADB 2002a, p. 1.
- <sup>30</sup> The national poverty line in Indonesia is calculated by the Central Bureau of Statistics (BPS) as the expenditure necessary for a fixed food basket that allows an intake of 2,100 calories per person. The National Socioeconomic Surveys (*Susenas*) are the main sources of information on poverty in Indonesia. Based on *Susenas* of August 1999, the poverty line (Rp/capita/month) was 89,845 for urban areas and 69,420 for rural areas. Respectively, poverty incidence was 12.4 million (15.1%) and 25.1 million (20.2%) (Holloh 2001, p. 12).
- <sup>31</sup> ADB 2002a, p. ii.
- <sup>32</sup> World Bank 2002b.
- <sup>33</sup> ADB 2001, p. 2.
- <sup>34</sup> World Bank 2002a.
- <sup>35</sup> McGuire, Conroy, and Thapa 1998, p. 142–143.
- <sup>36</sup> ADB 2001, p. 12.
- <sup>37</sup> *Ibid.*, p. 43.
- <sup>38</sup> Excluding the village units and village service posts of BRI.
- <sup>39</sup> BI 2001, p. 137.
- <sup>40</sup> Chou 2000, p. 38.
- <sup>41</sup> Holloh 2001, p. 8.
- <sup>42</sup> ADB 2002a, p. 10.
- <sup>43</sup> BRI 2001a, p. 44.
- <sup>44</sup> Robinson 2002, p. 147–149.
- <sup>45</sup> Seibel and Parhusip 1998.
- <sup>46</sup> *Ibid.*

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- <sup>47</sup> BRI 2001b, p. 37.
- <sup>48</sup> ADB 2003.
- <sup>49</sup> Robinson 1994; BRI 1997.
- <sup>50</sup> Holloh 2001, p. 197.
- <sup>51</sup> *Ibid.*, p. 33.
- <sup>52</sup> This function is delegated to the provincial offices of the ministry.
- <sup>53</sup> BDB 2001, p. 3.
- <sup>54</sup> Holloh 2001, p. 51–52.
- <sup>55</sup> *Ibid.*, p. 57.
- <sup>56</sup> *Ibid.*, p. 52–63.
- <sup>57</sup> Patten 1999, p. 8.
- <sup>58</sup> Robinson 1994, p. 30–32.
- <sup>59</sup> BRI 2001a, p. 44.
- <sup>60</sup> Charitonenko, Patten, and Yaron 1998, p. 35.
- <sup>61</sup> Maurer and Seibel 2001, p. 9.
- <sup>62</sup> Holloh 2001, p. 59.
- <sup>63</sup> A detailed historical account of BPR development is provided in Holloh 2001 (p. 62–65).
- <sup>64</sup> *Ibid.*, p. 76.
- <sup>65</sup> BI 2003.
- <sup>66</sup> As estimated in Holloh 2001, p. 72.
- <sup>67</sup> As estimated in ADB 2003.
- <sup>68</sup> Holloh 2001, p. 71.
- <sup>69</sup> ADB 2003, p. 23.
- <sup>70</sup> BPR portfolio at risk is defined as the outstanding balance of monthly installment loans in arrears for at least 3 months (Holloh 2001, p. 74).
- <sup>71</sup> *Ibid.*, p. 74.
- <sup>72</sup> *Ibid.*, p. 77.
- <sup>73</sup> *Ibid.*, p. 35–36.
- <sup>74</sup> Go 2002.
- <sup>75</sup> Based on December 2001 report on operational data of the pawn company (BI 2001, p. 147–148).
- <sup>76</sup> Fernando 2003, p. 3.
- <sup>77</sup> Holloh 2001, p. 35–36.
- <sup>78</sup> Fernando 2003, p. 4.

- <sup>79</sup> Sukarno 1999, p. 16; Holloh 2001, p. 86.
- <sup>80</sup> ADB 2003.
- <sup>81</sup> Holloh 2001, p. 33.
- <sup>82</sup> “The *Desa Adat* are village units in which customary symbols and regulations play an important role in community life and for social integration” (Ibid., p. 93). The *Desa Adat* are indigenous groups sharing common origin or social bonds and should be distinguished from village administrative units or other local government entities determined by territorial lines.
- <sup>83</sup> Holloh 2001, p. 97.
- <sup>84</sup> Ibid., p. 102.
- <sup>85</sup> Ibid., p. 137–141.
- <sup>86</sup> Ibid., p. 140.
- <sup>87</sup> The calculations are by Holloh (Ibid., p. 147). Net margin is calculated by subtracting financing costs (0.1%), operating costs (6.3%), and full loan loss provision costs (12.7%) from the average yield on performing assets (10.6%)—the financial income divided by average performing assets during the first half of 2000.
- <sup>88</sup> The classified-to-performing-assets ratio, as applied by BI for the BPRs, is a risk-based ratio that divides classified assets (here, the loan portfolio) weighted according to collectability by performing assets (here, interbank assets and loan portfolio). Classified assets include 50% of substandard assets, 75% of doubtful assets and 100% of loan losses. The loan loss reserve ratio is the second ratio used by BI to measure the quality of assets. The ratio divides loan loss provisions made by provisions required. The latter include 0.5% of standard loans, 10% of substandard loans, 50% of doubtful loans, and 100% of lost loans. A ratio of less than 51% would be rated unsound (Holloh 2001, p. 146).
- <sup>89</sup> Ibid., p. 146.
- <sup>90</sup> Ibid., p. 149.
- <sup>91</sup> Ibid., p. 142.
- <sup>92</sup> Ibid., p. 143.
- <sup>93</sup> Multipurpose cooperatives are those that incorporate the functions of two or more types of primary cooperatives. Primary cooperatives types are credit, consumers, producers, or service.
- <sup>94</sup> Holloh 2001, p. 160.
- <sup>95</sup> Ibid., p. 162.
- <sup>96</sup> Cooperatives (and credit unions) in developing countries generally have a three-tier structure. The primary or individual institutions may organize themselves into a secondary cooperative or federation to form a network. These in turn may organize themselves into a tertiary cooperative or confederation for an even wider network.
- <sup>97</sup> Holloh 2001, p. 163.
- <sup>98</sup> Ibid., p. 174.
- <sup>99</sup> Ibid., p. 176.
- <sup>100</sup> Charitonenko, Patten, and Yaron 1998, p. 21.

- <sup>101</sup> Robinson 2002, p. 11.
- <sup>102</sup> BRI 2001a, p. 44.
- <sup>103</sup> Holloh 2001, p. 64, 67.
- <sup>104</sup> Ibid., p. 68.
- <sup>105</sup> Ibid., p. 44.
- <sup>106</sup> Timberg 2003, p. 2.
- <sup>107</sup> BI 2001, p. 152.
- <sup>108</sup> Holloh 2001, p. 43.
- <sup>109</sup> BI 2001, p. 153.
- <sup>110</sup> Prins 2000.
- <sup>111</sup> Holloh 2001, p. 174.
- <sup>112</sup> ADB 2003, p. 6–8.
- <sup>113</sup> Holloh 2001, p. 58.
- <sup>114</sup> Schreiner 2002, p. 11.
- <sup>115</sup> An institution is financially self-sufficient when it has enough revenue to pay for all administrative costs, loan losses, potential losses, and the cost of funds. Financial self-sufficiency is defined as total operating revenues divided by total administrative and financial expenses, adjusted for low-interest loans and inflation.
- <sup>116</sup> Robinson 2003, p. 405.
- <sup>117</sup> Robinson 2003, quoting from Steinwand (2001, p. 228, 303).
- <sup>118</sup> Yaron, Benjamin, and Charitonenko 1998.
- <sup>119</sup> Maurer and Seibel 2001, p. 15.
- <sup>120</sup> Ibid.
- <sup>121</sup> ADB 2003, p. 5.
- <sup>122</sup> Holloh 2001, p. 37.
- <sup>123</sup> ADB 2003, p. 6.
- <sup>124</sup> This area in the decree is JABOTABEK (the greater Jakarta area including Jakarta, Bogor, Tangerang and Bekasi).
- <sup>125</sup> Holloh 2001, p. 84.
- <sup>126</sup> ADB 2003, p. 6.
- <sup>127</sup> Hendrik Prins of the ADB Rural Microfinance Project preparatory technical assistance team shared an insightful analysis of Indonesian cooperatives that is the basis for many of the issues discussed in this subsection. He states that his analysis was based on existing cooperative laws and regulations, brief discussions with officials of the Ministry of Cooperatives in Jakarta, and field trips to Central and East Java, where meetings were held that included officials of district governments involved with cooperatives (*dinas koperasi*). (See Prins 2000)

- <sup>128</sup> BI 2001, p. 149.
- <sup>129</sup> Maurer and Seibel 2001, p. 14.
- <sup>130</sup> Holloh 2001, p. 48.
- <sup>131</sup> Kompas 11 November 2000, as cited in Holloh 2001, p. 58–59.
- <sup>132</sup> Charitonenko, Patten, and Yaron 1998, p. 51.
- <sup>133</sup> Holloh 2001, p. 59.
- <sup>134</sup> Yaron, Benjamin, and Charitonenko 1999, p. 23.
- <sup>135</sup> Charitonenko, Patten, and Yaron 1998.
- <sup>136</sup> Maurer and Seibel 2001, p. 13.
- <sup>137</sup> Holloh 2001, p. 59.
- <sup>138</sup> Maurer and Seibel 2001, p. 13.
- <sup>139</sup> Holloh 2001, p. 56.
- <sup>140</sup> Prins 2000.
- <sup>141</sup> Holloh 2001, p. 106–107.
- <sup>142</sup> *Ibid.*, p. 150–151.