MICROFINANCE INDUSTRY REPORT

Indonesia

2009

Produced by The Banking with the Poor Network in collaboration with the SEEP Network
Funded by the Citi Foundation as an activity of the Citi Network Strengthening Program

Citi Foundation

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B.W T.P.
Banking With The Poor Network

FDC

The SEEP NETWORK

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ii. Foreword

This assessment was completed as a Banking with the Poor Network (BWTP Network) activity within the Citi Network Strengthening Program, in collaboration with the SEEP Network and funded by the Citi Foundation.

The Citi Network Strengthening Program supports the development of Industry Assessments for national and regional level networks. The purpose of the BWTP Network Industry Assessments is to provide an overview of the microfinance sectors in which the BWTP Network operates. These assessments aim to extend beyond the performance of individual institutions, and focus on the development of the microfinance market as a whole by being both descriptive and analytical in nature. The aim of these assessments is to provide an outlook on each industry that is a valuable resource to the BWTP Network, its members and the wider microfinance community.

The Microfinance Industry Report: Indonesia is a review of the microfinance sector in Indonesia, and constitutes a new contribution to the BWTP Network's Asia Resource Centre for Microfinance (ARCM). This assessment builds on a country profile completed by the BWTP Network in 2004.

The ARCM is based on dialogue and information exchange at national and regional levels in South and Southeast Asia, and aims to constitute a one-stop learning and information hub for BWTP members and other microfinance actors in Asia.

The ARCM promotes increased outreach and efficiency of financial services for the poor in South and Southeast Asia, services that are essential in the fight against poverty in the region, improving the lives of millions through asset building and increased income.

The ARCM has two main objectives:

- First, the ARCM aims to encourage partnerships and cooperation in Asia, among microfinance providers and supporters, and between providers and financiers, in order to increase financial support for microfinance schemes and to increase peer learning.
- Second, the ARCM aims to build a knowledge management platform accessible to all microfinance actors in the Asia region, in order to increase institutional capacity, to increase the dissemination of innovations, and to develop regional and sub-regional standards in microfinance.

A note concerning exchange rates

The Indonesian currency, the Rupiah (Rp), is subject to exchange rate volatility, while its very low unit value involves financial aggregates in the trillions. For purposes of international comparison, this study applies the arithmetically-convenient exchange rate of Rp10,000 per US dollar.

iii. Acknowledgements

The Microfinance Industry Report: Indonesia was produced by Global Innovation Consulting (GIC) under the direction of Jamie Bedson, BWTP Network Lead Coordinator and Asia Regional Representative at The Foundation for Development Cooperation (FDC).

The Microfinance Industry Report: Indonesia is also the result of a close and productive collaboration between Mr Frans Purnama CEO of GIC, the BWTP Network and the Foundation for Development Cooperation.

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iv. Acronyms

› **ADB**	Asian Development Bank
› **ARCM**	Asia Resource Centre for Microfinance
› **BDB**	Bank Dagang Bali
› **BKD**	Badan Kredit Desa
› **BKK**	Badan Kredit Kecamatan
› **BKKBN**	Badan Koordinasi Keluarga Berencana Nasional
› **BMT**	Baitul Maal wat Tamwil
› **BPR**	Bank Perkreditan Rakyat
› **BRI**	Bank Rakyat Indonesia
› **BTPN**	Bank Tabungan Pensiunan Nasional
› **BWTP**	Banking with the Poor Network
› **CAMEL**	Capital, Assets quality, Management, Earnings, Liquidity
› **FDC**	The Foundation for Development Cooperation
› **GEMA PKM**	Gerakan Bersama Pengembangan Keuangan Mikro Indonesia
› **GIC**	Global Innovation Consulting
› **GTZ**	German technical service providers
› **IFC**	International Finance Corporation
› **IMF**	International Monetary Fund
› **INKOPDIT**	Induk Koperasi Kredit
› **IPO**	Initial Public Offering
› **KSP**	Koperasi Simpan Pinjam
› **KUD**	Koperasi Unit Desa
› **LDKP**	Lembaga Dana dan Kredit Pedesaan
› **LPD**	Lembaga Perkreditan Desa
› **LPJK**	Lembaga Dana Kredit Pedesaan
› **MFI**	Microfinance Institution
› **NGO**	Non-Governmental Organisation
› **P4K**	Pembinaan Peningkatan Pendapatan Petani-Nelayan Kecil
› **PNM**	Permodalan Nasional Madani
› **PNPM**	Program Nasional Pemberdayaan Masyarakat
› **PPSW**	Pusat Pengembangan Sumberdaya Wanita
› **Pro-FI**	Promotion of Small Financial Institutions
› **SEEP**	Small Enterprise Education and Promotion Network
› **USAID**	United States Agency for International Development

1. Country Overview: Recent Socio-Economic Information

Indonesia has experienced great political and economic upheaval in recent years. In the past decade the country of 231.6 million people has experienced the Asian Financial Crisis, the fall of President Suharto after 32 years in office, its first free elections since the 1960s, the independence of East Timor, separatist demands from restive provinces and bloody ethnic and religious conflict. These events were punctuated by a number of natural disasters, the most recent of which was the tsunami that devastated the provinces of Sumatra and Aceh.

Indonesia's economic woes continue. Early 2008 economic predictions paint a gloomy picture. According to the ADB's Asian Development Outlook (2008),

> The gradual pickup in economic growth in recent years has led to some increase in employment, though at 9.1% in August 2007 the unemployment rate remains high compared with many East and Southeast Asian countries. Moreover, underemployment is also high at 27.6% of the labour force. While it could be argued that post-crisis Indonesia has not experienced economic growth rates necessary to significantly bring down unemployment and poverty, the growth that has been achieved has not been accompanied by a commensurate increase in employment. (ADB, 2008).

Although there has been some success in reversing the poverty increases suffered as a result of the 1997 financial crisis, poverty levels in Indonesia remain high and are not likely to decrease significantly in the near future. According to the ADB "[even though] the share of the population in extreme poverty (living on less than $1 a day) has declined over recent years to 8.5%, nearly half the population still live on less than $2 a day" (ADB, 2008). Table 1 provides an overview of the demographic and macroeconomic situation in the country.

At the aggregate level, the banking sector displays relatively low loan to deposit ratios and is not achieving its full capacity to finance income and employment growth through the provision of credit. Despite a number of recent reforms to the banking system, the Indonesian government has admitted that 'the banking system is not adequately performing its financial intermediation role and contributing to economic growth'. Particularly lacking is "the willingness or capacity to lend for infrastructure projects and small-and medium-sized businesses" (IMF, 2007b: 50).

Map of Indonesia

Table 1: Demographic and Macroeconomic Data for Indonesia

Criteria	2004	2005	2006
Total Population (thousands)	-	218.869	222.192
Economically Active Population ('000)	-	105.800	106.390
National Poverty Line (Rupiah per capita/Month)	122.775	129.108	151.997
Population below poverty line (%)	16.7	15.97	17.75
Literacy Rates (%)	90.4	90.9	-
Life Expectancy (yrs)	-	69.8	-
Annual Growth Rate of Population (%)	1.34 (2000 – 2005)	1.27 (2005 – 2010)	1.18 (2010 – 2015)
GDP (Growth Rate %)	5.05	5.60	5.50
Inflation Rates (%)	6.40	17.11	6.60
Interest Rates (%)	13.41	16.23	15.07
Exchange Rates (1 USD = Rp.)	9,790	10,330	9,520
Unemployment Rate (%)		10.26	10.45

2. Background to Indonesian Microfinance

Indonesia was one of the first countries to develop commercial microfinance in Asia, with regulated financial institutions providing the bulk of microfinance services throughout the archipelago. In addition to the success of commercial microfinance providers, Indonesia has also been a favourable ground for the development of numerous subsidised government programs, local and community-based financial institutions, cooperatives and NGOs.

Despite this proliferation of microfinance service providers, several studies have demonstrated that there is still an unmet demand for microfinance services, as a majority of rural households still do not have access to a source of funds from a semi-formal or formal institution. The regulated microfinance providers, commercial banks and BPRs (Bank Perkreditan Rakyat) follow commercial principles and tend to cover mostly the upper levels of the micro-enterprise market, at the district and sub-district levels, with loans of more than Rp. 3 million (US$300), while NGOs, cooperatives, and village-based institutions (BKDs) reach lower towards the end of the market but still have limited outreach in rural areas. Bank BRI units tend to lend primarily for investment purposes while BPRs are oriented to providing working capital. The BRI units are the dominant actors; they are estimated to receive about two-thirds of the savings mobilised in the formal and semi-formal microfinance sector and to make perhaps 40% of loans by value. BPRs have perhaps a 15-20% market share of the microfinance sector.

Indonesia has a long history of commercial microfinance, starting a century ago with the Badan Kredit Desa (BKD or Village Credit Organisation), which are village-owned banks offering microcredit on commercial terms. Approximately 5,000 BKDs operate in Indonesia nowadays. Sustainable microfinance in the commercial banking sector began in 1970 with the opening of Bank Dagang Bali (BDB), a private bank in Bali specialised in commercial microfinance, which built its success on the knowledge of microfinance clients and on state-of-the art savings products. Unfortunately, BDB was closed by Bank Indonesia (the central bank) in 2004 for governance reasons; the sustainability of BDB's microbanking business model was not an issue. Another significant set of institutions is operated by Bank Rakyat Indonesia (BRI), a major commercial bank. It has specialized microfinance 'units' which have been in existence for a quarter of a century. Both large commercial banks and smaller regulated financial institutions play significant roles in Indonesian microfinance. It is also notable that many of these institutions are owned by one or another of the various levels of government, central, provincial or local.

The generic term for small regulated financial institutions in Indonesia is 'Bank Perkreditan Rakyat' (People's Credit Bank, or BPR). These were introduced by Bank Indonesia in 1978. After the 1988 financial reforms (known as 'PAKTO 88'), new secondary banks were established, also called BPRs. Specific requirements for the licensing of pre-existing BPRs (capital, size of deposits) were set but never fully respected. Today, BPRs include licensed financial institutions, mostly privately-owned, that meet the criteria specified in the 1992 banking law. These numbered 1,796 in August 2008 (accounting for about 15% of the microfinance market), and there were almost 9,000 public rural financial institutions that are not licensed by Bank Indonesia. These can be categorised as generic BPRs, which include village-owned BKDs of Java and Madura, and the Lembaga Dana dan Kredit Pedesaan (LDKPs) or Rural Fund and Credit Institutions, owned mostly by provincial governments (or in some cases by villages).

In the wake of new financial reforms undertaken by the government in 1984, Bank Rakyat Indonesia transformed its sub-branch ('Unit Desa') network operating at subdistrict level. The outlets were transformed from loss-making channelling agent for the government subsidised credit program for rice cultivation (BIMAS) into commercial microfinance intermediaries. The unit network is now the largest and one of the most profitable rural microbanking networks in the developing world. During the 1997-98 financial crisis, most BRI microfinance clients kept their trust in the financial services offered by BRI

units; clients maintained and even increased their savings levels. The BRI Unit Desa system's survival during the crisis was in sharp contrast to BRI's heavy losses on its corporate portfolio. In fact, the bank as a whole became technically bankrupt, and had to be rescued by a public restructuring and refinancing program, as for the rest of the banking industry.

As a direct consequence of the financial crisis, 82 commercial banks were closed, 13 were nationalised and others recapitalised or merged. A number of the state banks were consolidated into a larger financial institution, the newly established Bank Mandiri. The BRI unit network's performance during the crisis saved BRI from being merged into this larger bank. With bank closures, many small depositors lost their savings, sustaining a severe crisis of confidence towards financial institutions.

Another significant player in the formal microfinance market is the state-owned pawnbroker, Perum Pegadaian, serving millions of low-income people. With these three main players (BRI units, BPRs, and the Pegadaian), the formal financial sector is the dominant force in Indonesian microfinance, and outperforms the semiformal and informal sectors by a large margin.

The semi-formal financial sector has had a much smaller role in the provision of microfinance in Indonesia. NGOs in Indonesia have not played a significant role in financial intermediation, but instead focused on social mobilisation, often participating in government poverty reduction programs. In recent years, a few NGOs have ventured into commercial microfinance, with the establishment of their own BPRs. One has acquired a small commercial bank in Central Java and others have taken advantage of post-Suharto political liberalization to operate cooperatives.

During the Suharto regime, the cooperative system was highly politicised and used as a vehicle to disburse cheap credit to targeted groups. The cooperative sector still suffers from political interference and also from weak regulation. In addition, in both the Suharto and post-Suharto periods, government programs have provided subsidised credit financing to targeted populations, using the commercial banking system to channel the funds. For example, to assist poor farmers, the Income Generating Program for Small Farmers and Fishermen (Pembinaan Peningkatan Pendapatan Petani-Nelayan Kecil, or P4K), provided soft loans through self-help groups. To reach women, the Prosperous Family Program implemented by the National Family Planning Coordinating Board (Badan Koordinasi Keluarga Berencana Nasional, or BKKBN) had a network of village outlets and operated through women's groups, by encouraging savings mobilisation and disbursing subsidised credit. Such programs are implemented by sectoral agencies and typically rate poverty-alleviation goals well ahead of any considerations of financial sector development. This major strand of Indonesian microfinance is discussed below (section VI).

Finally, Indonesia also has a long history of informal credit and savings schemes, comprising of Rotating Savings and Credit Associations (RoSCAs) or 'Arisan' in Indonesian, as well as other forms of traditional finance. However, most of these schemes have limited outreach and their sustainability is based more on social cohesion than on financial rigour. Literally millions of Indonesians are involved in such arrangements, in workplaces, social groups and villages and they are by no means the exclusive preserve of the poor.

3. The Banking System and Microfinance

As with other underdeveloped financial systems, commercial banks continue to dominate the Indonesian financial sector. But what is unusual about the Indonesian case is the degree of their importance in the microfinance sub-sector. Bank Indonesia records about 71 million bank accounts held in 2007, of which some 69 million were deposit accounts. Total population was close to 230 million and the economically active population was then around 108 million, suggesting far from complete access to the services of regulated financial institutions. A summary or 'headline' measure of access to financial services is available for Indonesia and some neighbouring countries. The World Bank has produced an estimate that 40% of the adult population of Indonesia has access to a bank account in a regulated banking institution (World Bank, *Finance for all*, 2008). This compares with proportions of 59%, 29% and 26% estimated for Thailand, Vietnam and Thailand respectively, and is around the same level as the PRC (42%).

Indonesia has quite a diverse banking sector, with a number of institutions reflecting a distinctive history of financial sector development. Broadly speaking however, regulated banks are either 'Bank Umum' (general commercial banks) or BPRs. The categories of regulated institutions are enumerated in table 2, which lists the varieties of commercial banks as well as the BPRs. Of 128 commercial banks, 31 are government entities (either 100%-owned or majority-controlled) including 26 Regional Development Banks (BPDs).

An idea of these banks' relative importance (in terms of deposits held and loans advanced) may be gained from table 3. Overall, the data show the continuing importance of the major state-owned commercial banks, which still hold about 37% of deposits and make 35% of loans, as compared with 42% and 43% for the private banks, respectively. The Regional Development Banks (BPDs) are also publicly-owned and, although much smaller, have the potential to play a significant developmental role at the local level.

The data support the impression that the banking system was not realising its full capacity for financial intermediation, with relatively low loan-to-deposit ratios among the Regional Development Banks (51%) and state banks (72%). Private commercial banks (79%) performed somewhat more creditably. The aggregate loan to deposit ratio in the banking system had been increasing in the several years up to 2007 and was at its highest level since the financial crisis of 1997-98. It remains to be seen whether the financial crisis which commenced in 2007-08 will reverse this favourable trend and diminish the capacity of the banks to finance growth and employment creation, including for micro-enterprises.

An important element in the growth of lending in recent years has been the expansion of credit for the officially-designated category of 'micro-, medium- and small-enterprises'. This growth reflected regulatory changes designed to facilitate such lending, as well as government suasion and the creation of mechanisms to channel credit for approved purposes to micro- and small enterprises and low income people. However much, perhaps most, of this funding appears to benefit households in intermediate or non-poor strata of Indonesian society.

A micro-enterprise is defined by Bank Indonesia, the central bank, as a sole enterprise having turnover not greater than Rp 100 million (USD 10,000). This might be thought somewhat high in a country with per capita GDP of around USD 1000. Bank lending for 'micro-, small- and medium-enterprises' increased significantly from 2004 after the election of President Yudhoyono, averaging 20% annual growth (table 4). These credits accounted for about half of all bank credit by 2007 and totalled some USD 52 billion. This amount comprised about 40% for working capital needs, some 9% for investment purposes and 51% for consumption. Apparently the greatest element in this lending is for consumption by middle-class and non-poor families. There does not appear to be an official estimate of bank lending for microfinance, excluding the small and medium enterprise sectors.

However, there is no doubt that funding for genuine microcredit via the banking system had also been increasing rapidly in the several years to 2007.

In terms of lower-income people and their loans, the Unit division of Bank Rakyat Indonesia (renamed 'Bank BRI' in 2004) had a total of 3.44 million micro-borrowers in its 'Kupedes' loan program with total loans outstanding at December 2006 of Rp.27.3 trillion (USD 2.73 billion). Among other sources, this lending was funded by more than 30 million savers who had deposited Rp38.68 trillion (USD3.87 billion) in SIMPEDES accounts.

Bank Danamon Indonesia (a private bank operating through its specialized micro-division, the 'Danamon Simpan Pinjam' or Danamon Savings and Loan) served a total of 400,000 micro-borrowers with outstanding loans of Rp.8.6 trillion (USD 860 million) in 2007. The average BRI micro-loan size was about Rp. 7.93 million (USD 793) per borrower, while micro-loans via Danamon Simpan Pinjam averaged Rp.21.5 million (USD 2150) per account. BRI units also have a non collateralized loan, with maximum amount of Rp 5 Million (approx USD 500) and maximum tenor of 2 years. Danamon Simpan Pinjam has a higher uncollateralized loan amount, up to 20 Million (USD 2000). The contrast between these most successful state and private commercial banks is instructive, both in terms of outreach and the loan sizes they are able to provide.

BRI built its success on demand-based financial products and the development of individual 'Units' (originally called 'Unit Desa' or 'village units') in a separate division of the Bank. The services offered by Bank BRI units are loan products, savings products, insurance, and money transfer services/remittances. The KUDEDES product, an individual loan, requires collateral and can be used for working capital and investment purposes. The SIMPEDES savings product allows unlimited withdrawals, attracts competitive interest rates and is guaranteed by the government. Bank BRI units have been the source of many innovations. For example, as a way to encourage more clients to open savings accounts, BRI launched bi-annual lotteries for SIMPEDES account holders. Each saver received free lottery tickets depending on their minimum monthly account balances.

In the context of commercial micro-banking, it is also worth mentioning the savings products of Bank Dagang Bali, even if this once-successful institution no longer operates. BDB built its success on savings mobilisation, with three different types of savings products: time deposits, giro account, and different types of passbook savings accounts. BDB's success in savings mobilisation was based on using mobile savings teams. Two staff undertook daily visits to depositors to collect deposits and pay out withdrawals. Like BRI, Bank Dagang also ran periodic lotteries, for which free tickets were given to savers based on their minimum monthly balance.

Bank BRI Units savings products are based on principles of trust, security, convenience, liquidity, privacy, linkages with loans and returns. A wide range of savings products is available, with different degrees of liquidity. Deposit rates increase with the minimum monthly balance, reflecting the higher costs of handling small accounts. A 'transfer price' is set for inter-lending between units and from the units to the bank itself. This manages the overall liquidity position of the bank. Savings accounts are used to build the client's credit rating, and credit collateral. Users of the major savings product, SIMPEDES, are permitted an unlimited number of transactions. This was introduced after field studies showed that limitation on withdrawals was the main obstacle preventing rural people from opening saving accounts.

Each BRI unit is treated as a profit centre and is financially self-reliant and subsidy independent. Bank BRI has always kept its Units aloof from government 'program' or policy lending, which is handled instead by the Bank BRI branch system. Historically, then, the Unit division has been shielded from the contagion attaching to many policy lending activities. At the end of September 2004, BRI was operating 4,049 units and 325 branches. Partial privatisation of BRI was a success; with an IPO and share listing on 10 November 2003, and shares fifteen times oversubscribed. The government sold approximately 30% of BRI capital.

At the end of September 2004, BRI had 87% of its loan portfolio in micro, small and medium enterprises, while corporate lending represented the remaining 13%. Some 31% of the Rp.58,119 billions (US$6.2 billions) in loans outstanding were related to the microenterprise sector, or Rp. 18,146 billions (US$1.9 billion).

The success of private lender Bank Danamon in microfinance lending has stimulated other commercial banks, such as BTPN , Bank Mega Syariah, Bank Mayapada, Bank NISP and Bank DIPO International, all of which are 'down-scaling' their operations to enter the microfinance sector. Prior to the current financial crisis, a state bank, BTPN (Bank Tabungan Pensiunan Nasional), with support from Texas Pacific Group (TPG), had signalled an investment of some Rp. 30-40 trillion in the next 5 years for microfinance operations. Bank Mega Syariah was programming 210 microfinance outlets in 17 cities. It is the pioneer among Islamic banks in the sector. Bank Mandiri, the biggest Commercial Bank in Indonesia, had announced its intention to open 300 new Microbanking units and to recruit 1,700 employees for the purpose in 2008. It was planning to increase microfinance lending to more than 10% of its portfolio.

It is important to distinguish between Indonesian banks engaged in micro-financing for strictly commercial reasons and those engaged by reason of a social mandate or in response to government suasion and regulation. This is not simply a matter of state ownership as against private enterprise; thus Bank BRI still has majority state ownership but pursues a strictly commercial agenda. Bank Mandiri is a state bank whose agenda includes both a 'social mission' and commercial considerations. Bank Danamon, a listed public company, is one of a number of private commercial banks alive to the commercial possibilities of microfinance and actively committing resources to the field. Other private banks feel it necessary to find an accommodation with government and/or central bank suasion and requirements. Thus (with varying degrees of enthusiasm) they employ some assets in microfinance, either directly or through linkages with smaller regulated financial institutions (BPRs). The BPRs themselves vary in regard to their interest in and capacity for micro-lending. Those owned by local governments and cooperatives are often more micro-oriented, while those under private, for-profit, ownership are often more focused on small and medium-sized enterprises. The BPRs are discussed in greater detail below.

In addition, most formal financial providers (commercial banks and BPRs) also operate specific units, branches and products using Syariah (Islamic) banking principles. Islamic banking is a significant force in the microfinance and financial sectors in Indonesia, in terms of volume of financial services provided and the number of outlets providing them.

All banks are aware of Bank BRI's success in financing its lending through savings mobilization, although most are not in a position to compete with it by reason of the restricted range of their branch networks. It is true that banks other than BRI face daunting establishment costs in expanding outreach. Bank BRI's rural network is the legacy of substantial government investment, much of it done before the 1980s, when commercial criteria were not so important. But the long recovery from the 1997 financial crisis, during which loan to deposit ratios were low, had also diminished incentives for commercial banks to open new branches to mobilise savings. More widespread competition for deposits, including those of the poor, must await a time when commercial bank lending becomes liquidity-constrained due to economic growth. This is not an early prospect under the financial conditions of 2008.

People's Credit Banks (BPR) or secondary banks were, as mentioned above, created in the 1970s and received a regulatory boost with the financial liberalization of 1988 (PAKTO 88). After this, new secondary banks could be established, also called Bank Perkreditan Rakyat. For those 'old' BPRs already in existence, specific requirements were set, in regard to minimum capital and other requirements, to bring them up to the level of the new class of BPRs. These requirements were never fully respected, leaving a situation in which a substratum of local-level financial institutions operates to this day in an ambiguous regulatory situation.

The 'new' regulated BPRs are much smaller than Bank Umum (commercial banks) and offer basic products only. BPRs are allowed to accept deposits, but are limited in terms of location, function and portfolio composition. They are locally based and mostly privately owned institutions, though some are owned by local governments of cooperatives. Since 1999, regulators have sought to encourage a consolidation of the BPRs, with larger but fewer entities. As a result, the creation of new BPRs has slowed down and many others have been closed down. Fewer than 1800 BPRs were operating in mid-2008, down from a total of 2,158 in 2004.

Today, BPRs include the small financial institutions described above that meet the criteria specified in the 1992 Banking law and almost 9,000 rural financial institutions such as LDKP, BKD and BKKs. These latter institutions are discussed below, in section VI. The licensed BPRs, which are regulated under the Banking Act, offer loan, savings and term deposits. They do not offer cheque accounts as they do not have access to the clearing system. They serve the middle segment of the microfinance market, generally chosen by clients who cannot provide enough collateral to access Bank BRI loans. They have mixed results and generally low financial performance, weak management and lack internal auditing and supervision. BPRs do not directly target micro-entrepreneurs and have been pushed by Bank Indonesia's regulations to do more conservative, collateralized, lending. These small financial institutions operating at local level can be publicly or privately owned and display some operational differences. Public BPRs generally enjoy local monopoly and do not compete with one another. They are in general more profitable than their private counterparts, which are frequently clustered and in active competition. Public BPRs are more energetic in mobilising savings and are willing to provide smaller loans. They are also more likely to engage in linkages with commercial banks, a process which Bank Indonesia is anxious to encourage. Private BPRs are generally more recently-established and are found in urban or peri-urban areas.

At March 2004 the BPRs were reaching 2.4 million borrowers and 5 million depositors, with a 77% loan to deposit ratio and a low 8% non-performing loan (NPL) ratio. Some 60% of BPRs were registered as limited liability companies, 36% as government enterprises, and the rest as cooperatives. At that date, licensed BPRs had Rp.13,430 billion (US$1.34 billion) in assets, of which Rp. 9,431 billion (US$ 940 million) was in loans outstanding. They had also mobilised Rp.2,665 billion (US$267 million) in savings, and Rp.3,360 billion (US$336 million) in time deposits. Subsequently, there has been rapid growth in these aggregates. By August 2008, loans outstanding were Rp.25.01 trillion (USD2.5 billion), while deposits totalled Rp.20.6 trillion (USD2.06 billion). The loan-to-deposit ratio had risen to 84.3% and NPls stood at 7%.

BPR savings are typically passbook savings accounts. They allow unlimited withdrawal and offer rates of interest which are normally positive after allowing for inflation. BPR time deposits are usually for periods up to twelve months. Rates of interest fluctuate greatly depending on location, bank ownership, size and other factors, but are also usually positive in real terms. In 2003, they collectively made Rp.429 billion (US$43 million) in profit, posting a 25% return on equity, and 3.4% return on assets.

Table 2: Regulated banking institutions, by category (2007)

State commercial banks	5
Regional Development Banks (BPDs)	26
Private commercial banks	67
Joint venture banks	19
Foreign commercial banks	11
Total number of commercial banks	128
Number of branches	9,888
Rural Banks (BPRs)	1,880

Source: *Bank Indonesia, 2008*

Table 3: Savings and deposits in the banking system, by bank category (2007)

Bank category	Total deposits in banks (in trillion Rps)	Average deposits per bank in each category (in trillion Rps)	Outstanding loans Rupiah (trillion)	Loan to deposit ratio (%)
State	485	96.1	348.9	72
Regional Development Banks (BPDs)	140	5	71.9	51
Private banks (with forex license)	520	15	432.5	79
Private banks (no forex license)	30	0.7	included in above total	included in above total
Joint venture banks	42	2.1	141.6	103
Foreign banks	95	8.4	included in above total	included in above total
Rural Banks (BPRs)	n/a	8.4 billion	n/a	n/a

Source: IMF (2007: 42b).

Table 4: Micro-, small- and medium-enterprise loans, as categorized by the central bank (billion rupiah)

Purpose of Loan	2008 (end- March)	2007	2006	2005	2004
Working Capital	204.321	204.765	171.118	142.653	111.636
Investment	45.194	44.578	37.147	33.049	28.460
Consumption	268.766	253.453	202.177	179.225	130.997
Total	518.280	502.796	410.442	354.908	271.093

Source: *Bank Indonesia*

4. Non-bank Financial Institutions in Microfinance

Perum Pegadaian is a large state-owned pawning company which provided microfinance services to more than 15 million customers in 2004 through a network of 812 branches. During that year, the pawnshops provided Rp.10,450 billion (US$1.05 billion) in loans, and generated a profit of Rp.230 billion (US$24.7 million). Pegadaian offers fast and efficient financial services, allowing clients to turn their valuables temporally into cash without having to sell them. It provides generally small loans with almost 90% less than Rp.500,000 (US$50) in 2001.

Other microfinance services are supplied by a semi-formal financial sector composed of thousands of non-bank financial institutions, such as Badan Kredit Desa (BKDs, or village credit organisations), and the LKDP, 'rural credit fund institutions', as well as finance and insurance companies, cooperatives, credit unions, and NGOs. It is a heterogeneous group, and the term 'non-bank financial institution' is used in this case simply to indicate that they are not banks, in the legal sense. Thus these institutions are not directly regulated by Bank Indonesia but registered and licensed by other state authorities and/or regional governments.

Established more than a century ago, BKDs were among the first microcredit institutions in Indonesia. They are small, village-owned organisations located on the islands of Java and Madura. They generally suffer from poor performance, weak management capacity and are often constrained by village bureaucracy. BKDs are supervised and administered through Bank BRI's branches, on behalf of Bank Indonesia. Managed by village leaders, BKDs offer savings and credit products to their clients. Compulsory savings are required in order to borrow but BKDs are not allowed to mobilise voluntary savings. Loans are typically of a small size, without collateral, and are processed quickly. BKDs usually open one day a week and the amount deposited by clients is transferred to the BKD account at BRI. BKDs finance their lending requirements through earnings on deposits, compulsory savings and borrowing from BRI.

LKDPs take different forms, such as the Badan Kredit Kecamatan (BKK), strong in Java, and LPDs, in Bali. They are supervised by local provincial governments. BKK Central Java is one example of a successful LDKP. It was born as a credit institution to target the poor and was allowed to accept savings only after 1984. It uses typical microfinance techniques; i.e. loans unsecured and character-based, small initially, then increased gradually according to repayment performance, loans paid in equal instalments, no collateral but mandatory savings. It has received technical assistance from USAID.

The Lembaga Perkreditan Desa (LPD) of Bali is considered the best LDKP system in Indonesia, despite strong local competition from a wide range of formal and informal financial institutions. LPDs are seen as profitable entities, which rely on savings and deposits as the main source of funding. LPDs were established from 1988 as village-owned financial institutions, with an economic and a social role in the community. They have received technical assistance from USAID and GTZ.

LPDs differ from the provincial government-controlled LKDPs in that they are owned by local community organisations. Membership is based on the 'Banjar', the most important unit of social organization in Balinese society. The social solidarity engendered by this is an important determinant of the success of the LPD system. In mid-1999, 910 LPDs served some 545,000 clients. This meant that over 80% of the Balinese population was reached by LPDs, a level unrivalled anywhere. The Balinese LPD and the BKKs account form a substantial part of the LDKPs that have not converted to BPR status.

The cooperative movement in Indonesia has a long history of politicization. Government-sponsored village-level cooperatives were established during the colonial period and cooperativism has a special place in the Indonesian constitution of 1945. In the Suharto period, state cooperatives, known as the 'Koperasi Unit Desa' or KUD, were considered to be one of the pillars of the Indonesian state. Currently, two types of microfinance cooperatives

exist; the credit and savings cooperatives, Koperasi Simpan Pinjam (KSP), and the savings and credit units (Unit Simpan Pinjam, USP) of multipurpose cooperatives. Most cooperatives are subsidised through their involvement in government credit programs. However, a few grassroots cooperatives have demonstrated stronger results. After the fall of Suharto in 1998 the repressive government control of cooperatives was loosened and independent cooperatives have begun to emerge.

The independent Credit Union Movement, supported by the Credit Union Coordination Board of Indonesia (Badan Kordinasi Koperasi Kredit or BK3I), appears to be more successful in nurturing independent and sustainable cooperative financial institutions. It has links with, and has been assisted by, various foreign cooperative movements. In 2004, INKOPDIT (Induk Koperasi Kredit) or the Credit Union Central of Indonesia also started a microfinance program to build the capacity of self-help groups to transform themselves into cooperatives. Some independent financial cooperatives are organized on Syariah principles and there is also a 'pre-cooperative' form of Syariah organisation, the BMT, which conducts savings and loan operations. The BMT is analogous to a self-help group. A state-established 'second-tier' institution, Permodalan Nasional Madani (PNM) provides loanable funds and capacity-building assistance for many of these Islamic financial institutions.

For historical reasons, having to do with the Suharto regime's discouragement of independent social action, NGOs have played a relatively small role in Indonesian microfinance. Compared with the large commercial operators in the field, NGO client numbers are generally very small. They can however deal with large numbers when providing non-financial services to assist government mass credit programs. For example, government programs use NGOs to facilitate the formation of self-help groups as conduits for microfinance services, usually provided by commercial banks such as Bank BRI. They usually mobilise savings, which are deposited in a BRI account, which will in turn channel subsidised government loans to the groups.

At present, the great majority of financial-service NGOs remain unsustainable and dependent on government or donor funds to operate. A few NGOs, such as the large Bina Swadaya organisation, have ventured into commercial microfinance by setting up their own BPRs. At least one commercial bank is operated by an NGO, Yayasan Purba Danarta in Central Java. Other NGOs use a modified Grameen Bank methodology.

Yayasan Mitra Usaha (YMU) is an example of an organisation which has adopted the Grameen approach and now reaches 12,000 clients. Mitra Bisnis Keluarga (MBK), or "Family Business Partners", is a microfinance institution also employing Grameen methods and regulated by the Ministry of Finance as a non-bank finance company. Currently it operates in six rural districts in Java and reaches nearly 80,000 members as of April 2008. MBK is the fastest growing and largest NGO-MFI in Indonesia and serves women exclusively.

Bina Swadaya (Self-Reliance Development Foundation) has helped self-help groups in many of the most disadvantaged areas of the country to link up with banks. It worked in the poorest villages identified by the IDT government program of the 1990s. Bina Swadaya has also set up its own BPRs and since 2002 has adapted the ASA methodology from Bangladesh in 7 of its 21 branches. Bina Swadaya has been a focal point for the articulation of microfinance concerns, being closely associated with GEMA PKM, a national forum for microfinance stakeholders. The GEMA conducted a survey of 55 microfinance institutions with Mercy Corps, an international NGO active in Indonesia. This identified a demand for wholesale funding and technical services for microfinance, as well as for rating services among more advanced MFIs.

PPSW is an NGO that works exclusively with women on a wide range of issues, such as economic and social development, migrant workers, reproductive health and education. In microfinance, PPSW aims to raise women's income through the development of community-based organisations, seeking to have them graduate to formal cooperative status. In 2001, PPSW began financing a secondary cooperative, KOPPERTI, to serve a network of primary cooperatives which are based on the aggregation of self-help groups.

After a long experience of collaborating with church-based NGOs and cooperatives, Catholic Relief Services decided to focus on BPRs. It established a wholesale fund, PT UKABIMA, to provide technical assistance and equity investment. Another entity, the 'Women Heading Households Empowerment Program', reports that female-headed households represent 13.4% of the 60 million households in Indonesia, with 50% being located in conflict-affected regions. The program, reaching 7,000 women in eight provinces, encourages the development of credit and savings associations to support business creation by women.

Table 5: Non-bank financial institutions engaged in microfinance, Levels of activity and numbers of clients

Type	Unit	Savings (Rp. Bn)	Saver	Lending (Rp. Bn)	Borrower	Avg. Size Loan (Rp. Mn)
Savings & Lending Coop. (KSP)	1,598	325.27	878,379	1,154.8	480,326	2.4
Savings & Lending Unit (USP)	36,485	1,454	10,524,908	13,495	4,987,783	2.7
LDKP	2,272	334	n.a	358	1,300,000	0.27
Syariah Cooperative	3,038	209	n.a	157	1,200,000	0.13
Credit Union & NGO	1,146	188.01	290,000	505.73	400,000	1.27

Source: *Ministry of Cooperatives and SMEs, Cooperative Statistics 2007*

5. Institutional Support for Microfinance

Indonesian microfinance is supported by a diverse set of institutions, originating from government, from voluntary sector agencies (both national and international), from the private sector and from bi- and multi-lateral agencies. The following is a description of some representative agencies and activities supporting the growth of the microfinance sector.

Pro-FI, the 'Promotion of Small Financial Institutions' project is supported by Bank Indonesia and the German technical assistance agency, GTZ. It aims to improve the operations of two categories of microfinance providers: the "People's Credit Banks" (BPR) and some non-bank microfinance institutions, especially the "Village Credit Boards" (LPDs) in Bali. It works through the trade association for BPRs, known as Perbarindo and aims also to strengthen Perbarindo itself by providing technical and management support. Pro-Fi provides support to the development of microfinance policies at national and provincial level and has been active in the attempt to secure a comprehensive law governing microfinance. It has also assisted in drafting new provincial legislation to support LPDs in Bali. The project supports the development of a training system to provide certification for BPR managers and directors. This is designed to upgrade their management skills and professionalism. Pro-Fi also promotes non-bank microfinance institutions in the provinces of Nusa Tenggara Barat and Nusa Tenggara Timor. Bank Indonesia has endorsed the certification program for the BPR system, as part of its efforts to strengthen the financial sector serving small and medium size businesses.

PERBARINDO is the long-established main national association of BPRs. It has been active in providing technical support to BPRs, and is currently involved in setting new standards of performance and training development with support from GTZ and Bank Indonesia. It has almost 1,600 BPRs as members with 80% operating in Java and Bali.

Permodalan Nasional Madani, or PNM, is a wholesale fund more engaged in serving SMEs than micro-enterprises. It is funded partly by government-mandated levies on profits of state-owned enterprises and by the transfer of funds formerly administered by Bank Indonesia. This was done to remove the central bank from the field of 'policy lending'. PNM supports linkage programs between commercial banks and BPRs, and between commercial banks and non-bank microfinance providers. Madani provides loans to non-bank microfinance providers through regional development banks (BPD), with savings mobilised by retail microfinance institutions as a unique form of collateral. It has a special brief for the support of Syariah (Islamic) microfinance.

GEMA PKM is the acronym of the Gerakan Bersama Pengembangan Keuangan Mikro Indonesia, the Indonesian movement for Microfinance Development. This was established in 2000 at the initiative of major national NGOs, including Bina Swadaya. The GEMA has become active in promoting microfinance in Indonesia through a diverse forum of industry stakeholders. It has more than 50 members, including formal financial institutions, NGOs and mass organisations, government programs and agencies, researchers and donor agencies. The forum was active in support of the Regional Microcredit Summit held in Indonesia in 2008 and has adopted the Summit's goal of extending the outreach of microfinance services to ten million of Indonesia's poorest families. It has also been active in support of the campaign for microfinance legislation and has lobbied for the establishment of an apex fund for non-bank microfinance providers.

GIC (Global Innovation Consulting) is a private Technical Service Provider established in 2007 and focusing on Microfinance. GIC provides technical assistance and consultancy services to the industry. The clients of GIC include the Asian Development Bank, GTZ, World Bank, CitiGroup, and individual MFIs, both conventional and syariah. GIC has offices in Jakarta and Singapore and provides services in Indonesia, Timor Leste and the Philippines.

BK3I is the Credit Union Coordination Board of Indonesia. It is the national apex organisation for financial cooperatives with links to the international cooperative movement. It managed to retain a degree of independence during the Suharto era and its member cooperatives should be distinguished from the Koperasi Unit Desa (KUD). These are the official cooperatives which provided the platform for many of the rural policies of the Suharto government.

MICRA is an NGO which performs a number of specialised functions for MFIs, donors, investors, commercial banks and government. Perhaps chief among these is a financial ratings service designed to provide expert, independent evaluation and verification of individual MFI performance. It uses the 'PRIME' rating tool, developed jointly by MICRA staff and IFC PENSA (a resident World Bank entity in Indonesia). In turn this is part of a joint IFC PENSA/Mercy Corps "Commercial Linkages Pilot Project". The rating tool is designed to promote transparency, improve performance and investment in the Indonesian microfinance sector. The tool is based on national and international standards in banking and microfinance and can evaluate MFIs at all levels of development, from start-up through to maturity, including Syariah institutions. It is gaining acceptance, although the investment required to undergo the rating is quite substantial for many MFIs. More recently, MICRA has benefited from the grant of some USD 19 million from the Gates Foundation, received via its founder, the US-based NGO Mercy Corps. This is being applied to create a 'bank of banks' which will serve as an apex lender to MFIs. MICRA has acquired an existing commercial bank for the purpose.

PT UKABIMA (Usaha Karya Bina Mandiri, meaning 'Self-reliance Corporation') is a private non-bank financial company established in 1996 through the support of USAID and Catholic Relief Services, Indonesia program. UKABIMA supports sustainable microfinance by improving the capacity of small rural banks (BPRs) to provide quality products and services to microentrepreneurs. As of December 2004 PT UKABIMA had provided wholesale lending to a network of 30 BPRs. The corporation also provides technical assistance such as training, due diligence and business consulting services, and support for MIS development, BPRs, local and international NGOs, cooperatives and others. To increase and deepen outreach, UKABIMA has also ventured into equity participation in BPRs and currently owns three BPRs in North Sumatra and Central Java.

PT. BISMA is PT. Bina Insan Sejahtera Mandiri, a private limited liability company interested in microfinance development. BISMA is oriented to commercial business, but chooses to position itself as a 'social-commercial' enterprise. BISMA describes itself as giving priority to providing social value on each of services delivered to the sector, not simply maximizing commercial benefit. It aims to secure partnerships, either in financial or technical services, with MFIs which have limited technical capacity and/or limited access to funding. BISMA's services can be categorized as follows: (a) Fund Placement/ Investment to support expansion of working capital resources of MFIs, aiming to trigger linkages between MFIs and commercial finance companies; and (b) Technical Services, providing incubation and other services to promote the technical skills of MFIs. The accumulated funding portfolio up until March 2008 was around Rp.60 billion (USD6 million) for almost 100 rural banks and cooperatives.

6. Financial Regulation, for Microfinance

6.1 Bank regulation

The legislation governing the banking system in Indonesia (the Banking Act, 1992 and amending legislation of 1998) provides for two kinds of banks. There are general commercial banks (Bank Umum) offering a full range of financial products. They have access to the payment system and provide general banking services, and foreign exchange services. They require a paid-up capital of Rp.10 billion (USD 1 million).The second category of bank is the Bank Perkreditan Rakyat (BPR). Initially set up with paid-up capital of 50 million rupiah, this requirement was increased in 1999 to RP 500 million rupiah (USD 50,000) for local areas. Minimum capital requirements were also increased for BPRs operating in the Jakarta region, from Rp.50 million to Rp.2 billion (US$200,000), and for provincial capitals to Rp.1 billion (US$100,000).

In 2003, with the amendment of the Bank Indonesia Act, the transfer of banking supervision from Bank Indonesia was mandated. A Financial Services Supervisory Agency (LPJK) now performs this function while Bank Indonesia retains responsibility for monetary policy and banking system development. BI also retains certain residual functions having to do with micro-, small- and medium enterprise financing (but not for refinancing such lending). These are discussed further below. In addition, the LPJK has special arrangements with other institutions to supervise on its behalf, such as BKDs supervised by Bank BRI branches. For supervising commercial banks, LPJK uses a CAMEL (Capital, Assets quality, Management, Earnings, Liquidity) rating system comprising seven ratios and 25 questions. For BPRs the six components of the CAMEL rating are employed in a simplified format. After the financial crisis of 1997-98, a drastic process of rationalization occurred in the commercial banking system, as described above. A parallel process occurred among the BPRs, whose numbers fell by some 400 to a total of 1,800 during 2008

6.2 Regulation of non-bank financial institutions

Lembaga Dana Kredit Pedesaan (LDKP), or 'Rural Fund and Credit Institutions', set up by provincial governments, have been encouraged to convert into BPRs but (as mentioned above) a majority have not done so. Therefore LDKPs are still licensed and regulated by provincial governments, while technical assistance and supervision is usually delegated to regional development banks (BPDs), also owned by provincial governments. While LDKPs are restricted in mobilising savings, a specific category of LDKP in Bali, the Lembaga Perkreditan Desa (LPD) or 'village credit board' is allowed by Bank Indonesia to accept deposits from members at village level, with the requirement that they do not describe themselves as banks. Semi-formal institutions such as LDKPs, LPDs, microfinance cooperatives, credit unions, and NGOs are outside the legal framework of banks, and have an unclear legal status in the financial system. This might represent a risk for small depositors in cases where such institutions accept deposits.

6.3 Cooperative regulation

Although a legal framework for cooperatives exists in Indonesia, their active supervision is hindered by the lack of capacity of the responsible central agency, the Ministry of Cooperatives and Small and Medium Enterprises. The cooperative sector is regulated by a government regulation of 1995 and a ministerial decree of 1998, which restricts credit and savings activities to financial cooperatives (KSP) or specialised units of multipurpose cooperatives (USP). Minimum capital requirements are also imposed.

6.4 The law on foundations

In 2001, following a series of abuses of the non-profit organisation status, the government passed the first ever law on foundations (the common form of NGOs in Indonesia). According to the law, foundations may only provide social, humanitarian and religious services and are prevented from being involved in income-generating or economic activities such as microfinance. Existing foundations were given

five years to conform to the new law, i.e. to cease their microfinance operations or to become BPRs or cooperatives. Some foundations that became specialised microfinance providers have faced a difficult challenge of converting to a new status, as they may have lacked funds or qualifications to become BPRs, or may have been reluctant to conform to the requirements of cooperative status. Legal deadlines often prove to be less than absolute in Indonesia and this situation may take some time to play out.

Table 5 shows the type of regulation to which microfinance service providers in the Indonesian financial system are subject. It distinguishes between those governed by the Banking Act, those subject to other financial regulation (for example under the Cooperatives Act, or powers vested in provincial and local governments) and those subject to no explicit financial regulation. This last category includes NGOs and self-help groups, which may be subject to other (non-financial) legislation or regulation. An example is the category of NGOs registered under the 2001 law on foundations. Proposals for more comprehensive regulation of MFIs have been under discussion for a number of years and this subject is discussed in the next section.

Table 6: Financial Institutions and Other Entities Engaged in Microfinance, Regulatory Status

Categories	Institutions regulated under the Banking Act	Institutions subject to other financial regulation	Entities subject to no explicit financial regulation
Commercial Banks (Bank Umum)	Commercial banks, government & private (incl BPDs)		
Other regulated banks Bank Perkreditan Rakyat (BPR non-BKD)	Peoples Credit Banks, or 'Rural' Banks, with private, local government or cooperative ownership		
Other regulated banks Bank Perkreditan Rakyat (BPR-BKD)	Badan Kredit Desa (BKDs, or Village Credit institutions)	BKD supervision ceded to Bank Rakyat Indonesia	
Non-bank financial institutions (local area) LDKPs		eg, BKKs, LPDs, subject to local government and BPD supervision	
Second tier entity PN Madani		Ministry of Finance	
Pawnshops Perum Pegadaian		Ministry of Finance	
Cooperatives, credit unions		KSPs & USPs, (incl Syariah, Iso credit unions. Subject to Cooperatives Act.	
Informal Development Financing Institutions: NGOs, unregistered MFIs, Self-help groups			NGOs, MFIs, BMT (*syariah*) Self-help groups.

Source: *adapted from Conroy and Budastra (2008)*

7. Government intervention, as it affects microfinance

The Indonesian financial system has a long history of state intervention, with central bank financing for 'policy lending' and credit allocation by state banks linked to preferential targets (e.g. farmers with the rice cultivation program). Until the 1970s, the central bank, Bank Indonesia, set rates and refinancing targets according to the priorities established for the economic sector. During the 1970s, a first wave of financial deregulation resulted in opening the capital account to foreign flows, although indigenous firms were still highly favoured. Following the oil crisis, the 1980s saw further deregulation with credit ceilings abolished, interest rates liberalised and preferential refinancing curtailed. In 1988, a deregulation package, called PAKTO 88, offered new banking licences, such as for BPRs, and relaxed regulations on bank branching and deposits. During that time, BRI's rural 'Unit' system was restructured and set out on the path of successful commercialization of microfinance.

In the 1990s, the government undertook a further reduction of subsidised loan programmes and made an upward adjustment in refinancing rates. The 1992 new Banking Act removed distinctions between development and savings banks. With new private and foreign banks established, competition with state banks increased and interest rates in the commercial sector were fully deregulated. In 1994, after a scandal related to the Indonesian development bank (Bapindo), Bank Indonesia strengthened its control over non-bank financial institutions, and provided a more selective licensing policy. The late 1990s and the financial crisis saw a major restructuring of the financial system, with bank closures, mergers, and heavy public recapitalisation. The government extended a guarantee on bank deposits and certain bank liabilities to prevent a bank run. Even during the crisis, some microfinance providers remained profitable, among them numbers of the BPRs, BRI's Unit banking system (as distinct from the larger bank of which it was a division) and the privately-owned Bank Dagang Bali.

Bank Indonesia has had an active role in supporting the development of micro-, small- and medium-scale enterprise credit, through the Suharto era to 1998 and subsequently. It was active in credit policy, institutional development and technical assistance. Under new central bank legislation of 1999, Bank Indonesia was required to surrender the last of its refinancing functions to a new entity, Permodalan Nasional Madani (PNM). As a second tier institution created specifically for the purpose, PNM took over Bank Indonesia's SME loan portfolio and some of the agricultural cooperative loans, with Banks BRI and Mandiri responsible for the balance. Madani and the banks are resourced for this purpose by 'on-budget' financial allocations by central government. This was a further step in a campaign, commencing from the early 1990s, to end the funding of 'policy' lending by means of central bank liquidity creation. However some support for the renewal of such measures exists within the legislature. The possibility of a populist revival can never be excluded, given the revolving wheel of Indonesian politics.

Despite the emergence of PN Madani, Bank Indonesia still has some functions in relation to micro-, small- and medium-size enterprise development and financing. It sees the BPRs as having an important role in providing financial services to these enterprises. Through banking policy, designed to create a new and more effective 'Indonesian banking architecture', it encourages commercial banks to enter into 'linkage' arrangements to lend to BPRs. PN Madani, as mentioned above, also supports this program. Bank Indonesia has also encouraged capacity building of BPRs by implementing a certified training system and extending technical assistance and support for information technology with the help of German technical service providers, GTZ and Bankakademie.

Until 1988, public support for a variety of rural development strategies, employing cooperatives, state and commercial banks, NGOs and mass organizations, often involved the channelling of credit to targeted groups during the Suharto

period. Two such mass programs, the 'P4K' (in agriculture) and the 'Prosperous Family' (associated with family planning) were described in section II above. Beginning in the crisis recovery period (from 1998-99) such activities accelerated, with a proliferation of recovery initiatives involving credit. These have been succeeded in the new century by anti-poverty schemes, often created in response to political pressures. Many of these government and international agency development programs include a microfinance component. This has resulted in a complex set of formal and informal financial institutions operating in a widespread network of official programs, with some limited scope for NGOs to act as facilitating agents. These are often implemented without much regard to microfinance best practice. Sources of cheap funds, sustainable only so long as external support continues, have proliferated. These have posed unfair competition for commercial microfinance providers, discouraged potential new providers and undercut non-commercial entities seeking to operate sustainably.

A study prepared for the Asian Regional Microcredit Summit in 2008 listed 14 central government agencies and departments conducting 18 programs involving 'revolving funds' with a combined budget of Rp 5.33 trillion (USD 533 million). The Ministry of Finance has struggled to bring this set of activities, with all their potential for politicization, rent-seeking and resource misallocation, under control and some degree of scrutiny. A government regulation of 2005 appears to have strengthened its hand in this regard. However the paradox remains that in Indonesia it is possible to see examples of populist 'micro-credit' and best practice 'microfinance' operating side-by-side. This is possible, firstly, because of a general under-provision of financial services and, secondly, because the two camps serve different social strata for the most part. The BRI Units deal mainly with the middle class and near-poor, while the 'schemes' (at least notionally) target the poor.

Efforts have been underway for some years, at least since 2001, to achieve the passing of comprehensive microfinance legislation capable of resolving such contradictions. A microfinance law was seen as necessary to clarify the status of a broad range of microfinance institutions not falling under the authority of Bank Indonesia and the Banking Act. These efforts were initially driven by a joint Bank Indonesia-GTZ financial sector development project (Pro-Fi) and were supported enthusiastically by the GEMA PKM, the peak body of Indonesian voluntary MFIs. The Ministry of Finance appears also to have seen value in efforts to rationalize the sector. Not surprisingly, such an enterprise was not welcomed by all of the many interests engaged in disbursing credit and benefiting from it. Consequently, progress in drafting the Act and getting it passed has been slow. Legislation was promised by end-2005 but has not eventuated.

More recently, the National Development Planning Agency (Bappenas) appears to have assumed responsibility for the microfinance legislative agenda. It did so in the broader context of the Indonesian Medium Term Development Plan, 2005-2009. In a chapter devoted to micro-, small- and medium-enterprise, the plan called for action to 'increase the institutional capacity and quality of services from the Micro Financial Institutions … and of the savings and loans cooperatives and undertakings'. This would require 'providing certainty on their status as legal entities, facilitating the licensing procedure, providing incentives to the establishment of the network system among the Micro Financial Institutions and between the Micro Financial Institutions and Banks'. It would also require 'support[ing] efforts for the enhancement of the quality and accreditation of secondary [savings and loans cooperatives and microfinance]' institutions. Bappenas appears to see these measures as necessary preliminaries to phasing out subsidised credit delivered by non-financial agencies and to professionalising the myriad of small financial institutions not regulated under the Banking Act.

Currently, the largest microfinance program in Indonesia is a part of the National Program for Community Empowerment or Program Nasional Pemberdayaan Masyarakat (PNPM). The PNPM, launched in August 2006, is the Government's primary poverty alleviation program and is a multi-faceted program covering health, education, water and sanitation, infrastructure and governance. The program builds on the Kecamatan Development Program (KDP) and Urban Poverty Program (UPP) which have operated from 1998 and 1999 respectively. The program receives significant support from the World Bank.

The micro-credit operations of the KDP and UPP programs have been considered inconsistent in terms of repayment rates and the majority of programs have not reached operational sustainability. Efforts are being made to ensure that the PNPM, in both its rural and urban incarnations, learns from the lessons of previous programming in aiming to achieve international best practice. Program design options are currently being finalised and therefore it remains to be seen the extent to which PNPM microcredit will improve on previous government programming.

8. Opportunities and Challenges

In general, formal financial service providers tend to reach the top end of the microfinance market, while at the bottom of the financial services pyramid, poor households and rural micro-entrepreneurs outside the main towns are still underserved. The outreach of microfinance services in rural areas remains limited, as most commercial institutions, such as BPRs and Bank BRI Units tend to focus on district capitals and regions of high economic activity, such as Java and Bali. A number of factors underlie this situation:

- The further expansion of Bank BRI's Unit network seems constrained by the 'cash cow' status it has within the bank and by the high capital requirements to open new branches or to operate in regions of lower population density, especially outside Java and Bali.
- Bank BRI units have been overly conservative in lending, and still fall short of their potential in terms of outreach in rural areas. By focusing on borrowers with fixed income or collateral, they have excluded a majority of typical microfinance clients.
- The regulatory environment for MFI non-bank financial institutions is not conducive to their strengthening and institutionalisation. They operate under conditions of uncertainty over such matters as legal identity, eligibility to mobilise deposits and the jurisdiction of various levels of government.
- Supply-led microcredit programs initiated and subsidised by the government do not provide a conducive environment for sustainable microfinance providers to operate.
- There is a lack of awareness and application of good practice microfinance principles among government agencies and semi-formal organisations, as well as some commercial banks that have entered the microfinance business recently. There is still no central microfinance training provider in Indonesia.
- Technical assistance and capacity building support to microfinance providers have been limited by the diversity and geographical spread of institutions. Only a few organisations have benefited from non-financial support. The ProFI project of GTZ and Bank Indonesia has recently tried to address this problem so far as BPRs and some other regulated non-bank institutions are concerned. There is a substantial gap in capacity-building for less formal entities.
- There is no formal credit bureau in Indonesia which could be used to monitor credit risk and over-indebtedness in areas of strong microfinance competition. Banks involved in microfinance, such as BRI units and BPRs do exchange information on their clients on an informal basis.
- Micro-finance institutions in Indonesia offer only limited financial services. For example, only the BRI Unit system has an integrated system of money transfer since it is part of Bank BRI. Current regulations prevent cooperatives and BPRs from engaging directly in remittance services However, recently some rural banks have cooperated with third party providers of money transfer services to complement their existing savings and lending products. A few large cooperatives have also partnered with third party providers of money transfer services. This is an important area of public policy which lags behind technical developments and community needs.
- The demand for leasing products is evident in the Syariah cooperatives and the wider development of this service is required.
- Facilities for micro-insurance are in demand by MFIs to permit better risk management of lending programs. This demand has not yet been addressed by insurance companies.
- Micro-credit for housing, disbursed by MFIs for low-income households to construct or renovate their houses through self-help or communal activity (gotong royong) is a pressing need which is not yet being adequately supplied or targeted. The State Ministry of People's Housing is providing subsidised credit to be delivered via MFIs, but there are questions as to the targeting of these funds. If microcredit is delivered with a 'shelter' focus for the incremental improvement of the dwellings of the poor, this lending can be done sustainably.

8.1 Future prospects

Indonesian microfinance will continue to grow, both in size and degree of sophistication. It will contribute to the financial inclusion of the poor and of other unbanked people. This will contribute to poverty alleviation, both directly and by accelerating the process of financial deepening. Among activities best positioned for growth, and with major welfare benefits for the poor and near-poor, is the development of affordable financial services for money transfer. Despite regulatory prohibitions and technology costs, many microfinance institutions already have experience providing money transfers using licensed third parties.

Another area of opportunity lies in rapid technical advance in information and telecommunications technology. Since most potential micro-borrowers live in rural and remote areas while MFIs are mostly located in sub-district towns, the transportation and opportunity costs for both borrowers and field staff are very high. The opportunity represented by mobile-phone banking is evident from experience in the Philippines, as elsewhere in the region. The dissemination of cell phones in rural areas lags behind some regional neighbours, but the infrastructure and consumer demand are developing to the point where the mobile banking opportunity can be grasped.

External challenges faced by Indonesian microfinance flow from the influence of the global economy. The spike in petroleum prices affected the viability of micro-enterprises, quite apart from the impact on the formal economy. Plans for expansion of micro-banking announced by major commercial banks are threatened by developments in the macro-economy. In addition, the growing trend for foreign investment in MFIs has probably rendered them more vulnerable to external shocks than was the case at the time of the previous crisis in 1997.

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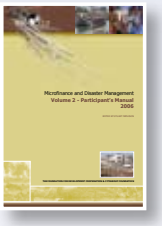

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