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ACRONYMS

ADB  Asian Development Bank
b  Billion
BAPPENAS  National Development Planning Agency
BI  Bank Indonesia: Central Bank of Indonesia
BKD  Badan Kredit Desa: Village Credit Board
BK3I  Badan Koordinasi Koperasi Kredit Indonesia: National Credit Union Coordination Board
BK3D  Badan Koordinasi Koperasi Kredit Daerah: Regional Credit Union Coordination Board
BKK  Badan Kredit Kecamatan: Sub-district Credit Board, LDKP in Central Java, Bengkulu, Riau, South Kalimantan
BMT  Baitul Maal wat Tamwil (Arabic term for: house & asset financing); non-bank microfinance institution, YINBUK/PINBUK
BPD  Bank Pembangunan Daerah: Regional Development Bank
BPR  Bank Perkreditan Rakyat: People’s Credit Bank
BRI  Bank Rakyat Indonesia: People’s Bank of Indonesia, commercial state bank
BUKP  Badan Usaha Kredit Pedesaan: Rural Credit Board, LDKP in Yogyakarta
BUMD  Badan Usaha Milik Daerah: Business legal entity owned by prov. govt.
CAMEL  Capital, Assets, Management, Earnings, Liquidity (soundness rating system)
CAR  Capital Adequacy Ratio
CRS  Catholic Relief Services
CU  Credit Union
CUCO  Credit Union Coordination Board
FSSI  Financial Services Supervisory Institution
GDP  Gross Domestic Product
Gema PKM  Gerakan Bersama Pengembangan Keuangan Mikro Indonesia: Indonesian Movement for Microfinance Development
GTZ  German Agency for Technical Cooperation
HRD  Human Resource Development
IMF  International Monetary Fund
INKOPDIT  Induk Koperasi Kredit: national secondary cooperative of Credit Unions/BK3I
KSP  Koperasi Simpan Pinjam: Savings and Credit Cooperative
KUD  Koperasi Unit Desa: Multi-purpose cooperative at sub-district level
LCS  Loan Classification System
LDKP  Lembaga Dana Kredit Pedesaan: Rural Fund & Credit Institution
LKK  Lembaga Kredit Kecamatan: Sub-district Credit Institution, LDKP in Aceh
LKURK  Lembaga Kredit Usaha Rakyat Kecil: People’s Small Business Credit Institution, LDKP in East Java
LLL  Legal Lending Limit (loan exposures)
LPD  Lembaga Perkreditan Desa: Village Credit Institution, LDKP in Bali
LPN  Lumbung Pitih Nagari: Village Credit Institution, LPKP in West Sumatra
LPK  Lembaga Perkreditan Kecamatan: Sub-district Credit Institution, LDKP in West Java
LPS  Lembaga Penjamin Simpanan: Deposit Protection System
MF  Microfinance
MFSI  Microfinance Supervisory Institution
MOA  Ministry of Agriculture
MOC  Ministry of Cooperatives and SME
MOF  Ministry of Finance
MFI  Microfinance Institution
m  Million
NBFI  Non-Bank Financial Institution
NGO  Non-Government Organization
<table>
<thead>
<tr>
<th>Acronym</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>OJK</td>
<td>Autoritas Jasa Keuangan - see FSSI</td>
</tr>
<tr>
<td>NTB</td>
<td>Nusa Tengara Barat (also known as Lombok Island)</td>
</tr>
<tr>
<td>P4K</td>
<td>Proyek Peningkatan Pendapatan Petani-Nelayan Kecil: Small Farmers’ Income Generating Project</td>
</tr>
<tr>
<td>PB</td>
<td>PERBARINDO (the association of BPRs)</td>
</tr>
<tr>
<td>Perda</td>
<td>Perusahaan Daerah: Provincial Government Regulation</td>
</tr>
<tr>
<td>PD</td>
<td>Perusahaan Daerah: legal entity owned by the provincial government (see also BUMD)</td>
</tr>
<tr>
<td>PHBK</td>
<td>Proyek Hubungan Bank dengan Kelompok Swadaya Masyarakat: Project Linking Banks and Self-help Groups, also: linkage project</td>
</tr>
<tr>
<td>PINBUK</td>
<td>Pusat Inkubasi Bisnis Usaha Kecil: Center for the Incubation of Small Businesses, regional chapter of YINBUK</td>
</tr>
<tr>
<td>PLPDK</td>
<td>Pusat LPD Kecamatan: Sub-district LPD Centers</td>
</tr>
<tr>
<td>PNM</td>
<td>Permodalan Nasional Madani: state-owned finance company in charge of liquidity credit programs</td>
</tr>
<tr>
<td>PPTA</td>
<td>Project Preparation TA</td>
</tr>
<tr>
<td>ProFI</td>
<td>Promotion of Small Financial Institutions</td>
</tr>
<tr>
<td>PUSKOPDIT</td>
<td>Pusat Koperasi Kredit: regional secondary cooperative of Credit Unions/BK3D</td>
</tr>
<tr>
<td>R&amp;S</td>
<td>Regulation &amp; Supervision (includes enforcement)</td>
</tr>
<tr>
<td>Rp.</td>
<td>Indonesian Rupiah</td>
</tr>
<tr>
<td>S&amp;L</td>
<td>Savings &amp; Loans</td>
</tr>
<tr>
<td>SHG</td>
<td>Self-help Group</td>
</tr>
<tr>
<td>SME</td>
<td>Small &amp; Medium Enterprises</td>
</tr>
<tr>
<td>TA</td>
<td>Technical Assistance</td>
</tr>
<tr>
<td>TPSP</td>
<td>Tempat Pelayanan Simpan Pinjam: Savings and Credit Service Posts</td>
</tr>
<tr>
<td>UED-SP</td>
<td>Unit Ekonomi Desa-Simpan Pinjam: Village Economic Unit-Savings and Credit</td>
</tr>
<tr>
<td>UPKID</td>
<td>Unit Pengelola Keuangan Desa: Village Fund Management Units</td>
</tr>
<tr>
<td>USAID</td>
<td>United States Agency for International Development</td>
</tr>
<tr>
<td>$</td>
<td>US Dollar</td>
</tr>
<tr>
<td>USP</td>
<td>Unit Simpan Pinjam: Savings and Credit Unit (of multi-purpose cooperative)</td>
</tr>
<tr>
<td>t</td>
<td>trillion</td>
</tr>
<tr>
<td>WB</td>
<td>World Bank</td>
</tr>
<tr>
<td>WG</td>
<td>Working Group</td>
</tr>
<tr>
<td>YINBUK</td>
<td>Yayasan Inkubasi Bisnis Usaha Kecil: Foundation for the Incubation of Small Businesses, NGO</td>
</tr>
</tbody>
</table>
1. MICROFINANCE AS PART OF THE INDONESIAN DEVELOPMENT STRATEGY

Micro-enterprises form the backbone of the Indonesian economy and society. A favorable investment climate, a conducive business environment as well as provision of and access to finance are major prerequisites for starting or expanding (micro-) business activities.

Microfinance as part of the financial landscape is an important sub-sector of the Indonesian economy which can significantly contribute to the government plans to increase employment and wealth of the population. The microfinance sector can be very important in terms of reducing vulnerability, enhancing business activities, generating employment and increasing income.

However, the potential of microfinance has not yet been fully unleashed due to a lack of coherent policy and strategy in this field. The core problem is that low-income households and micro-entrepreneurs with demand for microfinance services have only partly and limited access to sustainable and growing financial services which is a severe hindrance for the further development of the MSME-sector, where 98% of the Indonesian population find employment.¹

1.1 Rural Outreach is the Fundamental Problem

The major problem is that outreach into rural areas by banks is extremely limited, and usually not accessible on a day-to-day basis by villagers. Of particular importance is a BRI study from 2001² – “despite all efforts at financial deepening over the past three decades, the majority of villagers do not have access to financial services”. A ADB report from 2003 finds the core constraint to be the lack of safe, convenient and easily accessible savings facilities at the village level as well as reliable, flexible credit services for poor and low-income households.³ This was confirmed by a substantial GTZ Study⁴ that concludes that the major demand-supply gap in institutional finance exists at the village level. The GTZ report recommended closing the gap at the village level by:

a) expanding the outreach of existing MFIs (BRI units, BPRs, LDKP and KSP);

b) establish linkages between above and financial intermediaries at the village level;

c) strengthen existing intermediaries to develop into viable non-bank MFIs at the village level;

d) establish new non-bank MFIs at the village level (successful models here are BMT, LPD of Bali, and credit unions).

1.2 Poverty Concentration in Rural Areas

One consequence of the gap between supply and demand or rural financial services is the substantially higher incidence of poverty in rural areas (BPS statistics):

<table>
<thead>
<tr>
<th>Year</th>
<th>% Poor People (Headcount Index)</th>
<th>Number of Poor People (in million)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Urban</td>
<td>Rural</td>
</tr>
<tr>
<td>1990</td>
<td>16.8</td>
<td>14.3</td>
</tr>
<tr>
<td>1993</td>
<td>13.4</td>
<td>13.8</td>
</tr>
<tr>
<td>1996</td>
<td>9.7</td>
<td>12.3</td>
</tr>
<tr>
<td>1999</td>
<td>19.4</td>
<td>26.0</td>
</tr>
<tr>
<td>2002</td>
<td>14.5</td>
<td>21.1</td>
</tr>
<tr>
<td>2003</td>
<td>13.6</td>
<td>20.2</td>
</tr>
<tr>
<td>2004</td>
<td>12.1</td>
<td>20.0</td>
</tr>
</tbody>
</table>

¹ 1996 Census
² BRI Micro-banking Survey of October 2001 refers to the “un-banked majority”, i.e. the nationwide household survey found that 68% of the sample does not have credit from any formal or informal financial institution, and 62% don’t have a savings account with any formal or informal financial institution (page 37 of the Survey).
⁴ GTZ ProFI, Microfinance Institutions Study, 2001, page 196
Of Indonesia’s total population some 214m, some 17% live below the poverty line, with some 68% of poverty concentrated in rural areas.

### 1.3 Rural Economy needs Microfinance Services

Options for poverty reduction through agricultural growth in densely populated areas (particularly in Java that has some 60% of the total population) are reaching their limits. In densely populated areas, growth must come from alternative income producing activities, such as trading, permanent or temporary labor (construction, agriculture), manufacturing (especially home-handicrafts), agri-business transportation and services. In areas outside of Java, growth must continue to come from agricultural activities. BPS statistics for the end of 2001 show that in urban areas, employment is dominated by services (62%) and manufacturing (27%), whilst in rural areas by agriculture (65%), services (22%) and manufacturing (13%).

Whatever the activity, development and growth of micro-enterprise activities in rural areas is stifled by a lack of access to sustainable financial services, and this is particularly the case in parts of Java, Sumatra, Kalimantan, Sulawesi and the outlying (Eastern) islands.

### 1.4 Microfinance and Poverty Alleviation

It is increasingly recognized that well-targeted microfinance programs can help the poor pull themselves out of poverty. The underlying premise is that there is a vast and unmet demand for microfinance services from poor households and micro-enterprises, and that the provision of these services is an effective and proven way of reaching the poor, particularly women. Microfinance services, if provided on a sustainable basis, can have a significant effect on poverty reduction, and on the empowerment of women. However, reaching poor households and micro-enterprises with sustainable financial services is a difficult and time-consuming task that requires a long-term, multi-pronged strategy. Such a strategy will need to cover a wide array of issues including enabling policy environments, supervisory and regulatory frameworks, the provision of innovative financial technologies, and measures for social intermediation.

However, to achieve the above, the provision of microfinance services requires strong financial systems consisting of institutions that are committed to achieving sustainable financial viability. In addition, a supportive policy environment is essential. However, credit schemes, interest rate subsidies, and channeling credit through non-viable microfinance entities continue to undermine microfinance development.

In the Indonesian context, it is clear that microfinance systems can only become efficient and robust, and expand their outreach, if they operate within an appropriate financial infrastructure that underpins the process of financial development.

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5 Extracts from ADB publication: Microfinance: An Interim Action Plan, June 1998, pages 2 and 5. Re well-target schemes, ADB refers to some in Bangladesh and Indonesia's BRI unit system.

2. CURRENT STATUS OF MICROFINANCE INDUSTRY

2.1 Introduction

The microfinance sector in Indonesia can be divided into four segments: (a) microfinance programs, (b) rural banks (BPR) or commercial banks with microfinance windows (of which the largest by far is BRI), (c) the cooperative sector, and d) a vast informal sector, that includes money-lenders, traders, small self-help groups, informal S&L cooperatives, village credit institutions (e.g. UED-SP), etc.

A distinguishing feature of Indonesia is the small role played by NGOs in microfinance. This is in contrast to countries such as Bangladesh, Pakistan and the Philippines, where NGOs dominate or play a major role the microfinance sector, or countries such as Bolivia and Uganda, where NGOs that have converted to deposit-taking institutions dominate the microfinance sector. In Indonesia, their role is mainly confined to social intermediation, esp. linking self-help groups to financial institutions. Where they are directly involved in microfinance, the percentage of their participation to the total microfinance sector is very small.

2.2 Program Microfinance

Program microfinance comprises of both targeted credit programs (usually subsidized) and poverty alleviation efforts through microfinance components. The following discussion of program microfinance does not intend to be comprehensive and is given as an example of past and current program microfinance in order to present lessons learnt that are relevant for the microfinance policy and strategy.

2.2.1 Targeted (Subsidized) Credit Programs for Agriculture and SME

2.2.1.1 Agricultural Finance

Targeted credit programs in agriculture have a long history in Indonesia (e.g. BIMAS/INMAS in the 70ies), even though these programs have mostly failed to achieve the hoped for impact. Especially the Farmer Credit Scheme (Kredit Usaha Tani - KUT), a BI liquidity credit at subsidized rates for food crop production, introduced in 1985, undermined sustainable provision of quality financial services and with repayment rates of only 20% destroyed credit culture for years to come. The Food Security Credit (Kredit Ketahanan Pangan) was introduced in 2000 to follow up KUT. Banks use their own funds and assume the credit risk. Lending is to farmer groups at near market rates. For a transition period, banks’ lending rates were subsidized, e.g. 10% for paddy. In 2003 Rp880bn were allocated for the KKP. Due to particularities of and special risks associated with agricultural finance in the national microfinance policy and strategy special provisions for access to financial services by farmers need to be made.

2.2.1.2 MSME Finance

Also in the non-agricultural sector targeted credit schemes have been implemented since the 70ies. The Kredit Investasi Kecil, Kredit Modal Kerja (KIK/KMKP) schemes launched by BI in 1974 with highly subsidized interest rates (e.g. KIK 12% for a maximum of 8 years, grace period 4 years) suffered from low repayment rates. Thus, in 1993 it was decided to phase out BI direct provision of credit by BI. Under the Small Business Credit (Kredit Usaha Kecil – KUK) scheme banks are obliged to channel at least 20% of their loan portfolios to small-scale businesses. Whilst BI cannot provide credit anymore, it assists SME through credit policy and technical assistance. In April 2002 an MOU between BI and the Poverty Alleviation Committee promoted finance of micro and SME (MSME credit). Now there is a moral obligation on banks to expand credit to micro, SME by targeting these sectors in business plans. Loan sizes for micro-enterprises are up to Rp50m.

7 For a comprehensive overview of the MF sector, refer to the GTZ ProFI, Microfinance Institutions Study, 2001
8 World Bank Indonesia: Policy Brief “Finance for the Poor”
2.2.2 Poverty Reduction Programs with a Microfinance Component

Poverty alleviation has since long been a top priority of the political agenda. In this context the government embarked upon large national poverty alleviation programs such as the development program for backward villages (IDT), the family welfare income generation program (UPPKS), and the small farmer income generation project (P4K). Other programs such as the sub-district development and urban poverty alleviation programs were added in the second half of the 1990s and partly replaced the IDT program. In response to the ongoing economic, social and political crisis since 1997, the government, with support from the World Bank and other donors, launched several Social Safety Net (JPS) programs in the fields of food security, social protection in education and health, employment generation, and community empowerment. Some of these programs were set up to rapidly and directly channel funds and credit to the village level. Up to today a number of government programs on the national and sub-national level are carried out.

2.2.2.1 Programs on the National Level

Some 70 government sponsored poverty reduction programs are currently carried out at the national level and a number of these include microfinance or microfinance components. The following table gives an overview of 16 of these programs with budget allocations for 2002 totaling almost Rp3bn. However, the picture is unlikely to be complete as data on these programs is difficult to compile.

<table>
<thead>
<tr>
<th>Ministry/Institution</th>
<th>Program</th>
<th>Budget (Million Rp)</th>
</tr>
</thead>
<tbody>
<tr>
<td>National Family Planning Coordination Board</td>
<td>Family Welfare Income Generation Project (Usaha Penengkatan Pendapatan H Dasera, UPPKS)</td>
<td>1,370,833</td>
</tr>
<tr>
<td>Ministry of Agriculture</td>
<td>Rural Income Generation Project (RIGP) (Proyek Peningkatan Pendapatan Nelayan Kecil)</td>
<td>19,855</td>
</tr>
<tr>
<td>Ministry of Settlement and Regional Infrastructure Development</td>
<td>Urban Poverty Alleviation Project (Program Penanggulangan Kemiskinan di Perkotaan, P2KP)</td>
<td>438,910</td>
</tr>
<tr>
<td>Ministry of Industry and Trade</td>
<td>Partnership Program (Program Kemitraan) Establishment of New Entrepreneurship Business Clinic Development Revolving Fund Provision for Savings and Credit Groups (KSP) Microfinance Institutions (LM) Program</td>
<td>3,483 90,000</td>
</tr>
<tr>
<td>Ministry of Cooperatives and Small and Medium Enterprises</td>
<td>Capital and Financial Institution Strengthening through Provision of Initial Capital and Funding (P3LKM)</td>
<td></td>
</tr>
<tr>
<td>Ministry of Marine and Fishery</td>
<td>Management and Exploitation of Small Islands Empowerment of Coastal and Small Islands Population</td>
<td>8,225</td>
</tr>
<tr>
<td>Ministry of Home Affairs and Regional Autonomy</td>
<td>Kecamatan Development Project or Proyek Pembangunan dan Regional Autonomy Kecamatan (PPK)</td>
<td>1,028,000</td>
</tr>
<tr>
<td>Ministry of Women Empowerment</td>
<td>Women Empowerment through Local Economic Development (Pembangunan Perempuan melalui Pengembangan Ekonomi Lokal, P3EL)</td>
<td>4,000</td>
</tr>
<tr>
<td>National Land Use Agency</td>
<td>Land Use Management (land redistribution) for Sharecroppers</td>
<td>944</td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td>964,456</td>
</tr>
</tbody>
</table>

2.2.2.2 Programs on the Sub-National Level

Complementing programs at the national level are a number of sub-national programs such as the Nusa Tenggara and the Sulawesi Agricultural Area Development Project (NTAADP and SAADP): both were financed by a World Bank loan and implemented by the provincial planning agencies. The NTAADP covers 27 villages and aims at increasing income of village communities through improved farm systems, livestock production, microenterprise development and basic infrastructure development. NTAADP facilitates the formation of community groups, provides grants for infrastructure development and has established a revolving fund to finance agricultural and short-term productive activities based on proposals prepared by the village community groups.

As in the other projects, the NTAADP strategy includes the establishment of financial management units (Unit Pengelola Keuangan Desa - UPKD). This village-level units have the task of
managing program funds, provide guidance to community groups, assist them in preparing loan proposals, disburse and collect credit, and monitor community group activities. The UPKD is staffed with a chairperson, accountant, secretary and two additional persons who are responsible for administering the revolving fund and infrastructure projects. This bodies could be transformed into formal village financial institutions which is one aim of the national microfinance policy and strategy.

2.2.3 Assessment of Program Microfinance

The ADB study on Commercialization of Microfinance\(^9\) considered that in Indonesia the provision of subsidies to a range of otherwise non-viable financial intermediaries for on-lending is rife and a number of projects are wastefully expending resources in the creation of institutional arrangements that have no long term future without continued project or budgetary funds, and concluded that many interventions by governments, regional governments are contrary to best practices of microfinance.

The report finds that there are at least 16 programs for poverty alleviation under various ministries with a micro-credit component, with funds allocated in 2002 of $3 billion. The most common interventions comprise grants, revolving funds, heavily subsidized credit and semi-commercial credit. Accordingly, many of the programs have failed or are not sustainable.\(^10\) In addition, there is a tendency for almost every government department to establish its own MFIs, that can lead to a crowding-out of private sector microfinance initiatives. The report refers also to the spillover of effects on cooperatives. Their use to channel funds to targeted beneficiaries has completely corrupted the integrity of cooperatives as viable institutions.

It appears that apart from the P4K project, the government programs have not been successful. This is why a reorientation of the government’s policy and strategy to develop the micro-financial system in Indonesia is needed. This is in accordance with what the WB considers best international practice: “There should be a range of MFIs because of the diversity of demand and markets and to expand outreach” - as will be seen below, this is not present in Indonesia: all that is currently allowed by laws at the national level are micro-banks (BPRs) and cooperatives (that can deal only with members).

2.3 Institutional Microfinance

2.3.1 Legal Framework for Institutional Microfinance\(^11\)

National Level, Acts of Parliament: the 1992 Banking Act allows only banks to take deposits from the public. With respect to the microfinance sector, major banking participants dealing in microfinance are the BRI Units (the largest provider of microfinance services in the country), and the BPRs. The 1992 Cooperative Act allows registered cooperatives to take deposits from members. As will be seen, there are thousands of Savings and Loan (S&L) Cooperatives (KSP), and S&L units within multipurpose cooperatives (USP). Within a broadly defined “cooperative sector”, there are also credit unions and BMT, Islamic-based S&L cooperatives, but a large percentage of CUs and BMT are not registered as cooperatives. There are a number of laws that create legal entities.\(^12\)

National Level, Regulations: there are over 5,000 BKD (in effect small village-credit banks), most of whom have been in operation since 1905, operating under a pre-colonial regulation of the then Department of Finance.

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\(^10\) An exception here is mainly the RIGP/P4K project (BRI/Ministry of Agriculture)

\(^11\) For a detailed overview of the legal framework for MFIs, and regulation/supervision of MFIs, refer to supplementary appendix B to the Draft Final Report, ADB Rural MF TA referred to above, prepared by one of the TA’s consultants, Dr H. Prins.

\(^12\) Other Laws relevant to MF include a Companies Law, a regulation on Regional Enterprises (that are legal entities), a recently-passed Foundations Act (for NGOs), and a very old regulation of 1870 that allows registered associations to operate as legal entities.
**Provincial Level:** there are some 1,620 LDKP (Rural Fund & Credit Institution), operating under enabling provincial regulations. The 1992 Banking Act required LDKP and BKD to convert to BPR, but none of the BKD did so, and only some 30% of LDKP converted to BPR.

<table>
<thead>
<tr>
<th>Institution Name</th>
<th>Units</th>
<th>Loan (in 1,000)</th>
<th>Client</th>
<th>Savings (in 1,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>BPR</td>
<td>2,158</td>
<td>2,160,000</td>
<td>12,150,000</td>
<td>5,760,000</td>
</tr>
<tr>
<td>Badan Kredit Desa</td>
<td>5,345</td>
<td>410,000</td>
<td>200,000</td>
<td>460,000</td>
</tr>
<tr>
<td>BRI UNIT</td>
<td>3,916</td>
<td>3,100,000</td>
<td>14,182,000</td>
<td>29,870,000</td>
</tr>
<tr>
<td>KSP</td>
<td>1,097</td>
<td>665,000</td>
<td>531,000</td>
<td>na</td>
</tr>
<tr>
<td>USP</td>
<td>35,218 Na</td>
<td>3,629,000</td>
<td>na</td>
<td>1,157,000</td>
</tr>
<tr>
<td>LDKP</td>
<td>2,272</td>
<td>1,300,000</td>
<td>358,000</td>
<td>na</td>
</tr>
</tbody>
</table>

The “window” for BKD can be considered closed, since no new BKD have been established for many years. BKD will in the future fall in the third MFI window (non-bank, non-cooperative).

13 The “window” for BKD can be considered closed, since no new BKD have been established for many years. BKD will in the future fall in the third MFI window (non-bank, non-cooperative).
14 Bank Indonesia per December 2004
15 Bank Rakyat Indonesia per March 2004
16 Bank Rakyat Indonesia per December 2003
17 Cooperative & UKM Ministry per April 2000
18 Cooperative & UKM Ministry per April 2000

There are therefore at present a number of “windows” for microfinance:

a. BRI Units, and BPRs, under the Banking Law (deposits from the public)

b. for cooperatives, under the Cooperative Law (dealings only with members)

c. for a variety of MFIs, under national and provincial regulations (this industry is stagnant)

The microfinance policy and strategy will provide another “window” for taking deposits from the public. This will be a non-bank and non-cooperative window, enabled at the national level, but taken care of in a decentralized manner on a provincial level.

### 2.3.2 Types of Microfinance Institutions

#### 2.3.2.1 Overview

Indonesia’s financial service providers are manifold and can be distinguished between formal (primary commercial banks, secondary banks BPR and state-owned pawnshops), semi-formal and informal financial service providers related to the degree of regulation. The semi-formal financial sector is not subject to overall banking or financial market regulation, however, the institutions (rural credit fund institutions LDKPs, village credit institutions BKDs, savings and credit cooperatives KSHPs, savings and credit units of cooperatives, savings and credit service points TPSPs) are formally registered, while the informal microfinance providers consist of thousands of channelling groups and the ubiquitous rotating savings associations (arisans), microfinance NGOs, moneylenders and traders. Although first rural banks and the first commercial bank following Syariah principles were licensed in 1991 and 1992 respectively, official recognition was given to the existence of a dual banking system, conventional and Syariah-based, as part of the banking act of 1998. Parallel to the development of Islamic Banking, financial cooperatives based on Syariah principles (Baitul Maal wa Tamwil, BMT, and Baitul Tamwil Muhammadiyah, BTM) were established. They complete today’s broad institutional landscape of microfinance and the financial sector in Indonesia.

To meet the - partly - unmet demand for microfinance despite the remarkable outreach that an impressive number MFIs has achieved in extending savings and credit services, all stakeholders remain challenged to enhancing supply of financial services for all target client groups and closing financing gaps, thus remedying shortcomings and deficits in the local financial market. These gaps apply significantly to financing of MSME, agriculture, particularly smallholders and rural enterprises, public tasks of regional and local authorities as well as investments in environmental protection technologies.
Apart from BRI units (actually sub-branches of BRI branches), deposit-taking MFI are small. Total assets of all BPRs, for example, are less than 1% of total banking-sector assets. Systemic risk does not exist within the microfinance sector, although one could argue that there could be “systemic” risk within small geographic areas, e.g. with some of the very large LPDs in certain districts of Bali.

A special case in the institutional set-up are the Unit Ekonomi Desa – Simpan Pinjam (UED – SP) which are promoted by the Ministry of Home Affairs. According to the Ministry’s statistics from 1999 52,222 UED-SP had been established. Total loan portfolio was Rp116bn, i.e. Rp2.2 million on average. The GTZ microfinance institutions report describes the UED-SP as another top-down program of the government with emphasis on credit channeling. UED-SP cannot be regarded as a financial institutions owned and controlled by the village community as only a small minority of community members are UED-SP members. The institutions have the size of small credit groups. Under the microfinance policy and strategy they could continue to exist, but channeling of credit needs to be replaced by provision of sustainable microfinance services.

### Bank Perkreditan Rakyat – BPR (Peoples’ Credit Bank)

The Banking Act recognizes only two kinds of bank: Commercial Banks and BPRs. At the end of 2004, there were some 2,158 BPRs, with total assets of some Rp16.7 trillion, an average of Rp7.7 billion each. BPRs are efficient financial intermediaries, with deposits from the public some 90% of total loans. The industry is in reasonably good health, as the percentage of BPRs rated as sound or fairly sound has increased from 57% in September 1999 to 84.3% in December 2004.

### Constraint and opportunity: as will be discussed later, some 83% of BPRs are concentrated in Java and Bali – outreach to other areas is negligible. Another constraint is that about 50% of all BPRs are based in urban areas. A further constraint is that capital requirements for rural-based BPRs is Rp500m, too high for the economic viability for MFI operations in rural areas where population density is not as high as in Java. With increasing competition from microfinance units of commercial banks, BPR need to increase their efficiency in reaching their existing and potential clients. Thus, easing requirements for expansion into rural areas can provide BPRs with access to until now unbanked potential clients in rural areas.

### BKD

BKD (Village Credit Institution) are the oldest category of MFI in Indonesia, established under an empowering Law of 1929. There are some 5,345 BKD, all operating in Java, with total sector assets of Rp286 billion, average size per BKD Rp53.5m. Voluntary deposit mobilization is very small, or totally absent (compulsory deposits are taken, usually 10% of the loan amount, deducted when the loan is paid out). Capital funds 86% of total assets. BKD are not subject to prudential requirements, nor is there a soundness rating system for them. BI considers BKD to be

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| Pegadaian | 42 | 1,644 | 21,000 | No savings | No savings |
| BMTr | 3,038 | 1,200,000 | 157,000 | na | 209,000 |
| BK3D (Credit Union)K | 1,022 | 235,087 | 395,721 | 207,147 | 272,124 |
| LSMH | 124 | 162,314 | 110,008 | 81,931 | 11,969 |
| TOTAL | 54,232 | 9,234,045 | 31,733,729 | 36,379,078 | 40,686,593 |

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[20] Bank Indonesia per June 2000
[21] Pawn Broker Institute per July 2004
[22] Pinbuk per December 2001
[23] Credit Union HQ per December 2002
[24] 16 NGO’s from around 500 NGO’s per December 2003
[25] However, all data provided for this group is particularly questionable. Thus, the figures could not be included in the table above in order not to generate a wrong picture of the microfinance landscape and outreach.
banks (although they never obtained a license as a BPR), and has delegated supervision to BRI. The latter is constrained in this role, as it has no enforcement powers.

**Constraint and opportunity:** the industry is stagnant, and concentrated in Central and East Java. The proposed microfinance policy and strategy will enable existing BKD to expand, by allowing them to legally accept deposits from the public up to a certain level. By delegating supervision and support to the provincial level

### 2.3.2.4 Savings & Loan Cooperatives (KSP/USP)

Another large family of MFIs is the S&L cooperatives promoted and supported by the Ministry of Cooperatives (MOC). They comprise of single-purpose S&L cooperatives (KSP) and the S&L units (USP) of multi-purpose cooperatives. There are some 35,000 USP with total deposits of Rp1,157 billion and 1,079 KSP (Rp85 billion in savings). The cooperatives are reasonably efficient at financial intermediation (deposits are estimated at some 50% of total assets).

<table>
<thead>
<tr>
<th></th>
<th>KSP/USP sector 2002</th>
<th>KSP/USP sector 2003</th>
<th>Mean per KSP/USP 2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of KSP/USP</td>
<td>36,532</td>
<td>36,376</td>
<td></td>
</tr>
<tr>
<td>Number of members:</td>
<td>10,514,624</td>
<td>10,420,582</td>
<td>286</td>
</tr>
<tr>
<td>Total assets</td>
<td>6,792.7 billion Rp</td>
<td>6,197.1 billion Rp</td>
<td>170.4 million Rp</td>
</tr>
<tr>
<td>Loans outstanding</td>
<td>5,551.3 billion Rp</td>
<td>5,273.6 billion Rp</td>
<td>145.0 million Rp</td>
</tr>
<tr>
<td>Deposits</td>
<td>1,500.8 billion Rp</td>
<td>1,593.4 billion Rp</td>
<td>43.8 million Rp</td>
</tr>
</tbody>
</table>

Source: Ministry of Cooperatives, Perkembangan KSP/USP Koperasi Seluruh Indonesia, 2004

It has to be noted that many KSP/USP especially in urban areas are dealing with non-members – this is not allowed under the cooperative regulations. KSP/USP are subject to quite a comprehensive regulatory framework. It is apparent that supervision and enforcement are weak. There is no deposit protection system, and no national association of KSP/USP. The MOC is aware of the weaknesses of the system, but does not have the resources to remedy them. In addition, supervision and guidance has now devolved down to provincial governments.

A serious policy issue is the continued use by the Authorities to channel credit through KSP/USP, and the perception amongst many MFIs that the government continues to interfere in cooperative operations

**Constraint and opportunity:** due to weak supervision USP/KSP accept deposits from the public without any deposit protection system in place. In addition, their reputation within the general public is not favorable. Nevertheless, the cooperative sector is essential for provision of microfinance services especially in rural areas. Thus, the government’s supervision and support functions will be strengthened in the microfinance policy and strategy to allow sound growth of the sector.

### 2.3.2.5 BMT

Since 1995 YINBUK has been promoting Islamic-based cooperatives, called BMT (Baitul Maal wat Tamwil). There are around 2900 Islamic cooperatives (BMT), constituting 7.2% of all financial cooperatives, 2.9% of their deposits and 1.1% of loans outstanding. Borrower outreach is reported as 73,000 accounts, which is less than 1% of total borrower outreach of the financial cooperative sector.

Islamic cooperatives suffer from the same lack of supervision as conventional cooperatives and most BMT (83% according to a BI estimate) are not even registered with the Ministry of Cooperatives. After a period of rapid growth after 1995 when PINBUK assumed their promotion, they are now in decline; the majority of BMT now are assumed to be dormant or technically bankrupt. PINBUK has no power to enforce reporting, much less so prudential regulation; the Ministry has the power, but does not use it, and may in fact be an inappropriate organization to do so.

27 The validity of this figures is questionable.
Constraint and opportunity: BMT suffer from the same regulatory and supervisory neglect as the rest of the sector. After a period of rapid growth during most of the 1990s, they are now in decline, with perhaps not more than one-fifth expanding and in good health. Fresh money pumped into the BMT sector without effective regulation and supervision including mandatory auditing will further contribute to their downfall, as has been the case in the state-supported KSP/USP sector.

2.3.2.6 Credit Unions (CUs)

CUs in Indonesia are known as Koperasi Kredit. They are quite separate from the BMT and KSP/USP families. CUs have been promoted since 1970, and can be considered as a bottom-up movement. There are some 1,022 CUs, with total loans of Rp235 billion and Rp272 billion in savings. The movement follows traditional structures, with primary, secondary and apex institutions. However, since the movement has doubts about the benefits of being registered as a cooperative (KSP), only some 30% are operating as cooperatives. This means that some 70% of CUs are operating illegally. Contrary to KSP/USP and BMT, CUs deal only with members and generally require savings from members before qualifying for credit. Although savings and time deposits are only 21% of total assets, capital is 51% of total assets (capital includes compulsory savings), showing a sound position. As with BMT, the Cooperative Laws and regulations are generally not complied with. There is no internal deposit protection system, although a funds pooling system is operated.

Constraint and opportunity: the movement as a whole is showing little growth. However, lessons learned in this segment, especially concerning governance and management structures, provide valuable input for the overall cooperative sector strategy.

2.3.2.7 LDKP

LDKP (Rural Fund & Credit Institution) is a collective term for a variety of non-bank MFIs established by provincial governments. With the exception of the LPD of Bali (see below), most are owned by the provincial and district governments. As mentioned, the 1992 Banking Act required the some 2,244 LDKP at the time to convert to BPRs, but only 630 did so. Recent figures from BI reveal that there are now some 2,272 LDKP. The two major components of LDKP are the LPDs (over 77% of total sector assets), and BKK of Central Java (14% of total sector assets).

LPDs are village owned entities. Recent figures show that there are 1,296 LPDs in Bali covering 91% of the 1,423 villages (desa adapt), an excellent level of outreach. Financial intermediation is excellent, in fact, the sector is over liquid. Supervision of this sector is executed by the Regional Development Bank (BPD Bali) and soundness of the industry is very high (96.4% rated sound and fairly sound)

BKK (Sub-district Credit Boards) were the forerunners of LDKP. They are owned by the provincial and district governments, and there is one in each of the 510 sub-districts of Central Java. The owners of BKK quite diligently implemented the 1992 Banking Act requirement to obtain a license as BPR, and facilitated the conversion of 351 BKK to BPR. At the end of 2001, the sector had total assets of Rp676 billion ($75m), of which the weaker un-converted BKK comprise only some 17-20%. BKK are efficient at financial intermediation, and their operations are not confined to the village (as is the case in theory at least for LPD). The enabling regulation has provisions for guidance and external supervision. However, in common with all regulations for LDKP (excluding now the new one for LPD), there are no prudential banking requirements, and the supervisors have no enforcement powers. It is noted that another LDKP sub-family member, the LKURK of East Java, are implementing a sound strategy whereby eventually all 122 LKURK will either be closed or merged into one very large BPR. In January 2002, 66 of the strongest LKURK merged into PT BPR Jatim.

Constraint and opportunity: some 90% of total assets of LDKP are concentrated in Bali and central Java. Apart from the LPD of Bali, there is no growth in sector numbers. Provincial go-

Apart from Java and Bali, there are 122 LPN (a variety of LDKP) in West Sumatra, but their outreach is negligible, with total assets of only Rp2.5 billion (June 2000) – see GTZ ProFI Microfinance Report.
ernments in other provinces have not replicated the LDKP model, mainly because the Banking Law does not allow LDKP to take deposits from the public. The proposed new window in the microfinance policy and strategy will be a potent force for enabling provincial governments to expand the LDKP model into other provinces and rural areas.

2.3.2.8 Other Microfinance Providers

As mentioned before, BRI - Units are the largest microfinance system in Indonesia, with some 3,700 sub-branches operating as a separate profit center. The system is much more geared towards attracting deposits than providing credit (deposits at the end of June 2002 were Rp19.6 trillion, but loans were only 39% of this total). The legal framework is the Banking Act. By all accounts the system is efficient and well managed, however BRI’s own research confirms that outreach is very limited – the “unbanked majority” referred to above.

As mentioned, microfinance programs and projects proliferate in Indonesia (e.g. UED-SP, PHBK, P4K, UPKD), but are based either on self-help groups, or on very small MFIs. NGOs are not as dominant in the Indonesian microfinance sector as in many other developing countries, but there are some very large ones (e.g. Bina Swadaya), and they have formed an industry association. NGOs (Yayasan) now have a legal framework through a Yayasan (Foundation) Act of August 2001.

Constraint and opportunity: this segment is very fragmented and no one-fits-all strategy can be applied. The proposed microfinance policy and strategy will enable small MFIs and NGOs to operate without restriction, as long as public deposit taking is below a specified threshold. NGOs will be allowed to provide credit without restriction.

2.3.2.9 State-owned Microfinance Companies

Pegadaian (pawnshops) are one of the major providers of credit (short term liquidity) to rural and urban persons. Pawnshops are a government monopoly, with the state-owned company Perum Pegadaian operating 760 pawnshops with some 6,600 employees. Total assets are some Rp1.8 trillion ($200m). At the end of 2001, it had some 16 million borrowers. This substantial enterprise is subject to its own Law (Government Regulation of May 1999). Oversight is mainly internal (through a board of commissioners). In order to increase operational efficiency of the system, the government will privatize the pawnshops in the near future.

PNM (Permodalan Nasional Madani) is another very substantial state-owed company. It was established by a Government Regulation of May 1999. At the end of 1999 it took over BI’s role to manage government-funded credit programs, and it also independently provides funding for micro-enterprises and SME. PNM has 9 regional offices and some 350 staff. At the end of 2003, PNM net loans to MFI and SME amounted to Rp1.394 billion. PNM management has stated that it intends to expand its involvement in microfinance.
3. PROBLEMS WITH THE EXISTING MICROFINANCE SYSTEM

3.1 Outreach

The great majority of households, especially in rural areas still, do not have access to financial services. Reference has been made above to the “unbanked majority”. Whilst ongoing donor and government initiatives are targeting certain areas, at the national level, there has been no major initiative to expand the outreach of microfinance services nationwide. In addition, where there is some outreach, this is concentrated in Java and Bali, leaving most of the rest of Indonesia (with some 40% of the total population) in an even worse position.

As mentioned, BPRs are a very important segment of the microfinance industry. However, since the capital entry requirements were increased in 1999 (for rural areas, from Rp50 million to Rp500 million), new BPRs are unlikely to be founded in rural areas. In addition, 82% of BPRs are located in Java and Bali, and some 50% are urban based. Regulations regarding opening of branches for BPRs and mobile banking need revision in order to enable them to expand their outreach over time. However this particular family will not be sufficient to solve the problem of the “unbanked majority”, especially in areas outside of Java and Bali.

In Java and Bali, the provincial governments were mainly trying to expand microfinance outreach in urban and rural areas through the establishment of LDKP. Some 30% of existing BPRs were originally LDKP. However, the legal framework is unclear with respect to those BKD and LDKP that did not convert to BPRs: the 1992 Banking Law did not provide what the consequence would be if they did not convert. The law was however clear, that to take deposits from the public, the MFI must be a bank. Accordingly, most provincial governments in other areas did not replicate the LDKP model, knowing that this would contravene the Banking Laws. This has severely limited new initiatives at the provincial level.

3.2 Legal Framework

At present, at the national level, only two microfinance windows exist: for BPRs (under the Banking Law) and Cooperatives (under the Cooperative Law). MFIs have limited choice therefore: become a bank (where entry requirements are very stringent and cannot be satisfied by most applicants), or cooperative (but then be confined to dealing only with members). The framework is too restrictive and does not reflect actual practices, e.g. BMT (whether operating as formal or informal cooperatives) are dealing with the public.

The present legal framework in Indonesia has the result that most non-bank MFIs are not complying with the Banking or Cooperative Laws. Due to this situation responsibilities regarding regulation and supervision, support structures, etc. of microfinance families other than banks and cooperatives are not clear which impedes growth of this sector. Additionally, lack of a proper legal status inhibits integration of microfinance institutions in the financial sector and refinancing through banks or other financial institutions. Large-scale, sustainable microfinance can be achieved only if financial services for the poor are integrated into overall financial systems.

3.3 Regulation & Supervision

Apart from BPRs, the various microfinance families referred to above are not subject to adequate regulation and supervision. These MFIs are not part of deposit protection scheme. Large numbers of MFIs, even though individually very large, are not even legal entities. The current system limits the growth and development of MFIs, and their ability to participate in financial intermediation.

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29 For example, BKD and some 1,600 LDKP never converted to BPRs are required by the 1992 Banking Law. Some 30% of BMT and 70% of CUs are not registered as cooperatives (KSP). Registered KSP, especially in urban areas, are dealing with the public. Many NGOs are involved in financial services without any enabling law. Large numbers of informal MFIs are being promoted by regional governments, but are not operating under any legal framework.

If compelled to comply with the country’s laws, MFIs would prefer to register as cooperative, rather than seeking a banking license (as BPR) - the reason being that because regulation and supervision regime as well as the licensing requirements for cooperatives are easier to comply with. For example, if forced to become legal entities and to comply with the Banking or Cooperative Laws, most of the LPD in Bali would prefer to convert to KSP. This phenomenon, known as regulatory arbitrage, leads to creation of institutions which are cooperatives only in name, but have internal structures and policies which are not based on cooperative principles. This, in turn, overloads the institutions in charge of regulation, supervision and support, namely the Ministry of Cooperatives and SME.

3.4 Support Structures

The lack of an adequate legal framework creates a vacuum regarding responsibilities for regulating, supervising and supporting microfinance institutions other than banks and cooperatives. Together with tackling the legislative issue the government also needs to clearly assigning responsibilities for assisting the respective microfinance family and channeling sufficient funds into capacity building and institutional development of the microfinance institutions.

Especially in most of the existing government programs little or no emphasis is laid on capacity building and institutional development. For example, of the 2003 Budget Allocations for four major government programs (PMAMP, KKP, PKPS-BBM and PEMP) which amount to Rp3 billion, only 4.7% are spent on capacity building while 18% alone are spent on administration costs. Funds currently directed into subsidized credit schemes will under the new policy and strategy be used for capacity building and institutional development of microfinance institutions.

31 World Bank Indonesia: Policy Brief “Finance for the Poor”
4. INTERNATIONAL BEST PRACTICES

One major goal of the microfinance policy and strategy is to expand rural outreach by enabling MFIs that are not banks or cooperatives, to take deposits from the public within certain limits (geographical, threshold). This would require to set up a legal framework which accommodates a non-bank non-cooperative type of microfinance institution. In this chapter international best practices regarding the set-up of the legal framework for microfinance will be presented.

As this issue is closely related to creating an appropriate regulatory and supervisory framework in this paragraph a short explanation on prudential and non-prudential regulation will be given: Prudential regulation sets out the conditions for entry (licensing) and exit into a financial sector, and provides rules that have to be followed by members to ensure sound operations in order to protect the interests of depositors. The regulations cover amongst others such areas as capital adequacy, limits on loan exposures, a loan classification and provisioning system, liquidity requirements, a soundness rating system and a regime of sanctions and penalties for non-compliance. Supervision is to ensure that regulations are implemented, participants have to provide regular reports in prescribe format (for off-site supervision), and the Supervisor conducts on-site supervision to assess the accuracy of reporting to it and the directors’ ability to manage risk. Note: when prudential regulation is referred to, it should be understood that this includes supervision. Non-prudential regulation on the other hand consists of requiring entities to be registered, which they do mainly by providing details of their ownership, location, operations and management. There is no on- or off-site supervision. Once registered, all entities have to do is to provide annual financial and operational information. Also included in non-prudential regulation may be provisions to protect consumers and to prevent financial fraud. In the Indonesian microfinance policy and strategy, non-prudential regulation will be applicable to NGOs, MFIs providing credit only, or MFIs taking only compulsory deposits, but in all cases, only where their total assets are above a specified threshold. This information is necessary to ensure that MFIs are not taking deposits from the public above the threshold, and to provide policymakers with microfinance industry statistics.

4.1 Academic Background and Research

In recent years a number of studies have been published on international best practices and policies with respect to creating a conducive legal and regulatory framework. The best overview is given in the publications by the World Bank (1999), CGAP (2002) and GTZ (May 2003). A short discussion on the major findings of these studies and the implications on the Indonesian policy and strategy is given below.

4.1.1 World Bank

The WB states that most countries permit deposit taking from the public only by formally licensed financial institutions. It is considered that the source of funding differentiates a licensed MFI from one that is not licensed. The WB considers that there are thresholds that determine the regulatory approach to be taken. Essentially, there are NGOs (that use other people’s money, mainly from donors), cooperatives (that use members’ money), and licensed banks or MFIs that use the public’s money – in this case, the regulatory agency is the Bank Supervisory Authority. A specialized MFI that takes deposits from the public should be subject to prudential regulation. In a separate note provided by the WB to GTZ on microfinance regulation, entitled “Global Best Practices”, the WB refers to three levels of consideration:

32 The Consultative Group to Assist the Poorest (CGAP) is a consortium of 29 bilateral and multilateral donor agencies that support microfinance. Its mission is to improve the capacity of microfinance institutions to deliver flexible, high-quality financial services to the very poor on a sustainable basis. The driving force of CGAP is the World Bank. CGAP serves microfinance institutions, donors and the microfinance industry through the development of technical tools and services, the delivery of training, strategic advice and technical assistance, and action research on innovations. Re the microfinance industry, CGAP advice includes advising policy makers and regulators on the business environment, regulatory framework, and supervisory issues affecting the microfinance sector in a country.

33 A Framework for Regulating Microfinance Institutions, February 1999.
a. macro-level discussion about whether or not to develop specific regulatory frameworks for microfinance, or whether to adjust current frameworks to better accommodate microfinance.

b. technical level discussion about the framework most appropriate for each country, and in particular, a tiered approach to microfinance regulation that recognizes: (i) the benefits of developing a broad and varied range of intermediaries for microfinance, rather than a single model, and (ii) a corresponding set of tiers in regulation — progressing from registration as a basic minimum, to reporting and monitoring, and on to full-scale supervision.

One rationale for the microfinance policy and strategy is as set out in para. (b) above: the existing vast and diverse Indonesian microfinance system, and developments to the system, should not be confined to only two kinds of MFI: BPRs and cooperatives. There should be a broad range of MFIs, and the proposed new family of MFI, will deepen the microfinance sector as recommended by the WB. In a technical note on Indonesian microfinance, the WB amplifies para. (b) above, and provides a strong rationale for the Microfinance policy and strategy: “The financial system should create an enabling environment re policy, regulation and supervision for the development of a range of MFIs that can operate on a sustainable basis and can offer a variety of services to the poor and lower income households. There should be a range of MFIs because of the diversity of demand and markets and to expand outreach. And in this respect, of great importance is sequencing: the first area to address is policy and legal framework. Only when these have been developed, can the development needs of MFIs be identified.”

4.1.2 CGAP

A CGAP Position Paper states that most microfinance regulations, either existing or being proposed, are enabling, i.e. the purpose is positive – to allow the entry of new institutions or activities. “Where the purpose is to enable MFIs to take deposits from the public, then prudential regulation is called for. The reason therefore for regulation is deposit or (consumer protection)”.

The CGAP paper stresses that microfinance usually only accounts for a small part of most countries’ financial sector, however where a licensed MFI reaches a significant scale in a particular region or country, system risk issues must be taken into account, in addition to depositor protection issues. As stated previously, apart from BRI as a financial institution, no MFI in Indonesia is likely to become so large that systemic risk issues would be a concern at the national level.

One of the guidelines for prudential regulation of microfinance provided in chapter IV of the paper is to draw the lines based on small MFIs: small community or member based MFIs may be too small to be supervised on a cost effective basis. It is better to exempt community-based intermediaries below a certain size from the requirements of prudential regulation. Once the limits are exceeded, the MFI must comply with prudential regulation and be supervised. The microfinance policy and strategy takes this into account by requiring MFIs below a certain threshold to be non-prudentially regulated only. The paper also states that credit-only MFIs should not be subject to prudential regulation which is taken on the policy and strategy as well.

4.1.3 GTZ

The GTZ study supports the findings of the above described papers. Of specific interest, is to consider whether institutions or activities should be regulated (an issue raised by CGAP). An interesting deliberation which is relevant for the microfinance policy and strategy is on the issue

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34 The WB gives examples of two countries with a varied range of MF intermediaries: the Philippines has thrift banks, rural banks and cooperative banks, in addition to Credit Unions and S&L Cooperatives. Ghana has finance companies, rural banks, S&L companies and Credit Unions.


36 Regulation and Supervision of Microfinance, October 2002.

37 In the Indonesian context this includes allowing existing MFIs to comply with a legal framework.

of institutional and functional regulation. In most of the eleven countries, MFIs are regarded as a specific institutional type, regulated under a separate MFI Law. This approach is called institutional regulation. The functional approach, on the other side, regulates market participants according to the economic function they perform, regardless of their institutional structure. Thus, microfinance is seen as a financial activity rather than a specific institutional type. It is interesting to note that only the South African approach, which is a non-prudential regulatory framework, can be described as functional regulation. This is different for prudential regulatory frameworks, which must necessarily focus on institutions because, after all, it is institutions and not functions that become insolvent. No country in the sample has defined prudential regulations for microfinance irrespective of the type of institution that conducts microfinance business. It is therefore appropriate to look at MFIs as a distinct institutional type, even though the institutions themselves might operate under a different name.

4.2 Examples from other Countries

4.2.1 Bangladesh

Bangladesh is famous for its microfinance sector, but the legal framework for microfinance is very narrow, and very few of its MFIs are viable. In spite of this, outreach to the poor is extensive and probably unrivalled. The legal framework provides for only two kinds of MFI: Grameen Bank, established by special charter of the MOF in 1983 and supervised by the central bank, and NGOs registered under the Societies Act of 1860. NGOs follow the lending methodology pioneered by Grameen. Although there are some 585 NGOs providing microfinance, three large NGOs dominate the market: BRAC, ASA and Proshika. There are also financial cooperatives registered under the Cooperative Societies Ordinance of 1984, that permits them to take deposits from the general public in addition to members.

One study reports that the Registrar of Cooperatives conducts minimal to no supervision, and that MFIs (NGOs) may seek to register as a cooperative since there is minimal supervision. The central bank prefers not to allow NGOs to convert to banks, even if they could meet the capital entry requirement of $3.25 million. Note that although the largest NGOs now take voluntary savings to meet loan demand, these NGOs are not subject to any regulation or supervision. The vast majority of NGOs and Grameen bank are not self-sustaining, and rely on grants and subsidized funding.

4.2.2 Bolivia

Prior to 1995, the main institutions providing credit were Banks, Mutual S&L Companies (mainly housing finance) and Credit Unions (also with an emphasis on housing finance). In 1995, following GTZ policy advice, a new category of financial institution was created to provide microfinance called Private Financial Funds. These are limited liability companies, and require capital of $1m (banks require $3.2m). CAR must be at least 10%, and their activities are restricted as they cannot take demand deposits, engage in trade finance or make investments. To confirm their microfinance orientation, maximum loan size is 3% of capital. The legal framework includes NGOs that are major providers of microfinance. In 1992 a large NGO called PRODEM converted to Banco

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39 For a comprehensive overview of the legal frameworks of other countries, refer to GTZ publication “Regulatory Requirements for Microfinance”, A Comparison of Legal Frameworks in 11 Countries Worldwide, Stefan Staschen, Eschborn 2003. This includes a section on Indonesia’s BPRs.
40 See Regulation and Supervision of Microfinance Institutions, case studies, published by the Microfinance Network in 1997.
41 Above publication, pages 18-19.
42 This sentence is from ADB Paper on “Commercialization of Microfinance: Bangladesh” prepared by Stephanie Charitonenko and S.M. Rahman of Chemonics (September 2002).
43 Information for this section comes from the Microfinance Network publication referred to above.
Solidario (BancoSol), the first private bank in the world dedicated to providing microfinance services.\textsuperscript{44}

4.2.3 Cambodia

The Banking Act of November 1999 requires banks to be limited companies or cooperatives. A regulation (Prakas) under the Banking Act of January 2000 allows the licensing of rural-credit specialized banks, with a minimum capital of $2.5m (Rial 10 billion). Another regulation of January 2000 allows the licencing of MFIs – this created a new window for MFIs that are subject to prudential regulation. MFIs that cannot satisfy the licensing requirements (e.g. NGOs, associations, groups involved in credit services), are subject to non-prudential regulation, and must register with National Bank of Cambodia (NBC - the central bank). Only a licensed MFI can take deposits from the public. MFIs cannot engage in payment services through checking accounts or swap or forward dealings in foreign exchange (therefore, all other foreign exchange services are allowed). Restrictions can be placed on an MFI’s activities (this is likely to relate to extent of deposit taking and area of operations). The minimum capital requirement to be registered is Rial 250 million (US$50,000 at the date of the Banking Act – note that this is about Rp450m, a similar capital level for BPRs in rural areas). The Banking Act (article 27) provides that any influential shareholder (one who holds more than 20% of capital) can be required by NBC to increase the capital of a bank to meet solvency requirements. Failure to do so will result in penalties and possible liquidation of the entity. This provision is repeated in art. 7 of the regulation, with the provision that NBC can waive the requirements of the article, and that the provisions of the article will only be removed once a deposit insurance scheme is established in Cambodia.

4.2.4 Ghana

Ghana has established a reasonably sound legal framework for microfinance under the Banking Act of 1989 and Non-Bank Financial Institutions Act of 1993.\textsuperscript{45} The government recognises the importance and relevance of microfinance through the establishment of the Office of Microfinance Policy Coordination at the Ministry of Finance. MFIs are required to be legal entities. The tiered structure of formal financial institutions providing microfinance consists of:

a. Rural Banks, with a minimum capital of US$20,000. These are public companies owned by communities, with capital assistance from Bank of Ghana, and are licensed under the Banking Act. They operate under restrictions: no branches are allowed, activities are restricted to a clearly defined rural area, and they can only offer savings, time deposits and loans. Voting control however resembles cooperatives, because no shareholder has more than one vote. The government is sponsoring an Apex institution for these rural banks.

b. Savings & Loan companies, with a minimum capital of US$50,000. These are registered under the NBFI Act, can only offer savings, time deposits and loans (including hire purchase), but have some branching privileges. Private individuals own these companies, with voting rights depending on capital contribution. These entities seem close to Indonesia’s BPRs.

c. Credit Unions (CUs), registered under the Cooperative Act, and regulated by the CU Supervisory Board, a government agency. Under the NBFI Act, CUs are also required to be registered and licensed by Bank of Ghana. CU’s can only deal with their members. Note that Bank of Ghana is developing a set of prudential norms and guidelines specific to CUs.

d. NGOs engaged in credit activities are licensed under the Act on Trusts & Charitable Institutions. The legal framework facilities their transformation into licensed (and deposit-taking) MFIs.

\textsuperscript{44} Other examples of major NGOs that converted to bank are K-Rep in Kenya (shareholders include Shorebank Corp., IFC, African Development Bank, Netherlands Development Finance Co.) and ACLEDA in Cambodia.

\textsuperscript{45} Information on the legal framework was derived exclusively from a WB publication of April 2001: A Framework for Regulating Microfinance Institutions: The Experience in Ghana and the Philippines (Joselito Gallardo).
4.2.5 India

India has three types of institutions providing microfinance. Self help groups (SHGs) with more than 20 members are required by the Companies Act of 1949 to be registered as a society or trust. The largest microfinance program is one that links SHGs to banks, using NGOs as financial intermediaries, or intermediaries that promote and train SHG. India has a very large cooperative movement of about 90,000 primary agricultural credit societies, but most of them are no longer operational, and outreach to the poor is minimal. Cooperatives rely heavily on government funding and many are owned and controlled by state governments. The third category is NGOs, registered as a Society or Public Charitable Trust. NGOs are informally permitted to take savings, provided these are from “members”. India has a number of second-tier institutions that support microfinance, although only one appears to exclusively support microfinance, and is the largest: Rashtriya Mahila Kosh (RMK), which is registered as a Society. The governing board consists of government officials and representatives of NGOs. RMK provides loans to NGOs for on-lending to poor women.

4.2.6 The Philippines

The Philippines has a wide range of regulated and licensed bank MFIs and non-bank MFIs:

a. Thrift Banks, with a minimum capital of US$1m and $6.5m if the head office is in Metropolitan Manila. These are privately owned, and licensed under the Thrift Banks Act. They take deposits from the public, are supervised by the central bank, and enjoy deposit protection under the Deposit Insurance Company. These banks provide medium to long term financing to micro-businesses, SME and the public.

b. Rural Banks, and in their cooperative form, Cooperative Banks, under a Rural Banks Act. Minimum capital is $50,000 to $260,000 depending on the location. Their operation is limited to a specified geographic area, and services are limited to savings/time deposits and loans. Ownership is private. They take deposits from the public, are supervised by the central bank, and enjoy deposit protection under the Deposit Insurance Company. Rural banks provide finance to micro-businesses, SME and the public. These rural banks are very similar to Indonesia’s BPRs.

c. Cooperative Financial Institutions (CFIs): Credit Unions, and Savings/Credit Cooperatives. CFIs are registered under the Cooperative Development Act, and are supervised by the Cooperative Development Authority (CDA). Unlike in Ghana, these CFIs are outside the regulatory and supervisory jurisdiction of the central bank, and not part of the deposit protection system. CFIs may not accept deposits from the public. Apparently the ability of the CDA to effectively R&S CFIs is severely restricted, and there is no deposit protection for members.

d. NGOs, either controlled by trustees or private parties, operating as non-profit foundations under an Act on Trusts & Non-Profit Foundations, financed by grants and commercial loans.

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46 Information on India from above, p. 119.
47 A similar program linking banks and SHGs (PHBK) was sponsored by GTZ and BI in Indonesia in 1989, and by 1996 was operating in 16 provinces. Most of the participating banks are BPRs.
48 Apart from RMK, there is Small Industries Development Bank of India, that operates a micro-credit scheme, and National Bank for Agriculture and Rural Development that provides funding to NGOs for on-lending to SHGs.
49 Information from the WB publication of April 2001 cited above, and Regulation & Supervision of Microfinance Institutions, Case Studies, The Microfinance Network, 1997, pages 36-37. Information on capital requirements come from this study, and may be out of date.
50 Presumably thrift banks are classified as MFIs because most of their client base includes micro-enterprises. The WB also lists Finance Companies as MFIs, although their minimum capital requirements are $3.8m, they don’t take deposits from the public and they act as general financiers, rather than an entity with a MF lending orientation. The capital requirement for commercial banks is $48m.
51 On page 27 the WB notes that banking authorities in a number of countries are carefully assessing whether to place CFIs (especially where the volume of deposits have begun to approach or exceed those for small licensed banks) under the jurisdiction of the bank Supervisor (the countries referred to are Bolivia, Mexico, Ghana and the Philippines).
There is no Supervisory Agency, although the NGOs have reporting requirements to the Securities Exchange Commission (non-prudential regulation).

4.2.7 Other South American Countries

Apart from NGOs, Colombia does not seem have any specific legal framework for microfinance. Peru has a legal framework for 11 kinds of financial institution of which two focus on microfinance. Of interest here are the Cajas Municipales (CMAC) that are dedicated to providing microfinance (they take deposits from the public and can also provide foreign exchange services). Minimum capital is $256,000. These entities are owned by the provincial governments (like the BKK in Central Java). By the end of 1996 there were 12 of these entities. With GTZ assistance, a Federation of CMACs was established in 1983. The federation helps secure funding for members and acting under delegated authority from the central bank, supervises its members and provides training to their staff.

4.2.8 Sri Lanka

Sri Lanka’s legal framework provides for the operation of Credit Cooperatives and NGOs. At the end of 1996, there were 8,340 primary cooperative societies with a membership of 772,000. One writer states that the credit cooperative movement in Sri Lanka has been far more successful than in most other countries in the region. The Cooperative Societies Act of 1972 allows cooperatives to take deposits from persons who are not members; at the end of 1996, deposits from non-members were 15% of total deposits. The writer comments that the absence of prudential requirements reduces the credibility of such institutions, and that it does not seem appropriate for such institutions to take deposits from the public in their own right. NGOs are registered under various enabling Laws but are not allowed to take deposits whether from members or non-members; the restriction even applies to compulsory deposits. These restrictions are usually not enforced.

4.3 Lessons learnt

Many developing countries are expanding the legal framework for microfinance. A number of countries have established a tiered legal framework that allows new windows for MFIs. These windows create new institutions. Capital requirements vary from $20,000 to $1m. Some specifically allow the credit/savings operations of NGOs. The legal framework in Ghana appears to be the most comprehensive, and especially sound is the requirement for CUs to be licensed by the central bank, removing opportunities for regulatory arbitrage and improving the quality of regulation and supervision. Indonesia’s experience with cooperatives is similar to that of other South-East Asian countries with inadequate supervision. The Philippines also have a well-developed framework, with various tiers of MFIs and banks, and a well-developed system for channelling funds between MFIs through an Apex Bank. Even if few countries have as diverse a range of MFIs as Indonesia some countries have a far more comprehensive legal framework for MFIs. Thus, the intention of the microfinance policy and strategy is to expand and deepen opportunities for institutional microfinance.

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52 Information for this section also comes from the Microfinance Network publication.
54 The article “The Rush to Regulate” comments on the generally poor record of Government Cooperative Agencies in R&S of financial cooperatives, and states that there would seem to be a good argument for placing large financial cooperatives under the jurisdiction of the financial authorities, at least in those countries that have commercial-bank supervision reasonably well in hand.
5. THE INDONESIAN POLICY AND STRATEGY ON MICROFINANCE

In order to contribute to the development and poverty alleviation efforts of Indonesia, policymakers and the relevant stakeholders in the area of microfinance need to jointly implement a comprehensive microfinance policy and strategy which addresses the constraints described in chapters 2 and 3 above and which takes into account the experiences with microfinance worldwide and the longstanding history of microfinance in Indonesia itself.

5.1 Guiding Thoughts for the Policy and Strategy

In February 2004 governors and vice governors and other high ranking officials from ministries of finance or other authorities from ten Asian countries have reached agreement basic principles and guidelines for further developing their micro- and rural finance industries in line with their countries' poverty alleviation strategies. These guidelines which are outlined below already provide the framework wherein the Indonesian microfinance strategy will operate.

The Yogyakarta Communiqué assesses the shortcomings of interventionist, directed and subsidized credit policies and the longstanding and successful experience with commercially-oriented micro- and rural finance in Asia.

Key issues of the communiqué which provide the basis for the Policy and Strategy are:

1. Creation of a conducive environment for commercially-oriented micro- and rural finance. The key issues to be addressed comprise liberalizing interest rates and enabling deposit-taking as well as non-collateralized lending to facilitate institutional sustainability, deregulating market entry barriers to foster competition, and providing appropriate mechanisms for exit of unsuccessful institutions.

2. Setting in place an appropriate regulatory and supervisory framework to enable an effective oversight on activities of microfinance institutions, in ensuring the adoption of best practices for microfinance and stability of the financial system.

3. Promotion of cost-effective and efficient ways to regulate and supervise the micro- and rural finance sector to protect small savers and create a level playing field among deposit taking institutions.

4. Promotion of market orientation and avoiding of interest rate subsidies which endanger institutional sustainability and undermine deposit mobilization. Only if markets clearly fail, temporary subsidies may be justified. Subsidies must be implemented transparently and phased out gradually.

5. Active promotion of human resource development and Institutional capacity building through the government and central bank.

5.2 Common Guidelines for all Stakeholders in Microfinance

A number of efficient and sustainable financial institutions promote the poor population in their economic, social and political development by providing appropriately designed financial services. The aim of common guidelines for all stakeholders in microfinance is both to expand such existing experience to other financial service providers and to other regions of Indonesia and to mutually benefit from sharing experiences with other countries in the region about efficient and stable financial systems that support a pro-poor economic and social development policy.

To address the target client groups' financial services needs – as of MSME, rural poor / agricultural financing etc. – a coordinated approach will be applied, involving complementary stakeholders at various levels, safeguarding complementary and uniformity of approaches, economy of scale etc.). Common guidelines apply for the setup and mode of operation of the financial sector as for the regulatory system as a whole. Economic sectors and the national economy as such

55 Full text of the Communiqué see Appendix A
require a sound system of financial intermediation, transparent regulatory frameworks and effective supervisory mechanisms supported by the central bank.

Some more operational guidelines which can be applied by stakeholders in Indonesia in accordance with Donor Guidelines on Good Practice in Microfinance: Building Inclusive Financial Systems – CGAP draft 7 July 2004 e.g. human and institutional capacity of MFIs, innovative products and delivery mechanisms, fostering a conducive policy environment and ensuring appropriate role of government etc.

### 5.3 Key Principles of Microfinance

In order to reach a significant portion of the target client groups and to participate in financial system development in a sustainable way with efficient delivery and collection systems, all relevant policy makers and stakeholders in developing microfinance in Indonesia, commit themselves to apply in their present and future actions the key principles of best practice:

- Small-scale entrepreneurs and the rural working poor need a variety of financial services, not just loans. Like everyone else, the target population needs financial services that are convenient, accessible, flexible and affordable.

- Working with target group clients who do not have conventional collateral in a bottom-up approach, e.g. through member-based groups with strong local units supported by second-tier institutions with clear division of responsibility between them.

- Accepting the efficacy of self-regulating mechanisms and social pressure as a means to enforce performance and repayment since external supervision and legal action are not viable. Maximum of clients’ participation and ownership is appreciated.

- Rural community-based non-bank, non-cooperative financial institutions are accepted as financial intermediaries registered under a special legal and regulatory framework provided by sub-national authorities. They should be formed voluntarily and able to take responsibility for their own development provided there is extension support from institutions and a framework to guide such institutions. Communities should have a shared vision (common goal, bond, objective), constitution and proper management structure.

- In order to secure and sustain the activities, MFIs separate responsibility for financial and non-financial services. The costs of financial services are fully recovered by interest rates; therefore, any regulation in terms of interest ceilings shall be avoided on the one side. On the other side, high interest rates shall not make borrowers cover the cost of the MFI’s own inefficiency.

- Internationally accepted rules concerning prudential regulation and risk-based supervision of MFIs – as recommended by CGAP (Consultative Group to Assist the Poor) and endorsed by its 28 public and private development agencies – shall be agreed by all microfinance and complementary stakeholders in Indonesia.

- The need for non-productive loans in society is recognized and taken into account in credit supply. Despite the fact that priorities are on productive loans, loans can be provided as far as reliability of the borrower is a basic allocation principle, whether the loan is productive or not.

- Microfinance development is being considered as part of an integrated strategy, correlated with the regulatory system and economic development, on which target client groups need to have a clear idea, in line with development objectives with a strong emphasis on human and institutional capacity building. The national strategy will have a clear plan for actions and clear systems and procedures. It will link at national, regional, local levels, formal and informal MFIs, second-tier structures, supportive institutions and donors, integrated in an institutional microfinance network.
5.4 The 4 Pillars of the Policy and Strategy

The principles laid out therein lay a solid foundation and provide the framework for a microfinance and rural finance system which is demand-driven and responsive to the needs of the working poor. Accordingly, the three main aspects of the Indonesian micro-finance strategy are:

a) Reorientation of the Role of Government;

b) Conducive environment for commercially-viable and demand-driven microfinance and rural finance;

c) Prudential regulation and effective and efficient supervision;

d) Promotional role concerning human resource development and institutional capacity building.

5.4.1 Reorientation of the Government’s Role

The Government of Indonesia recognizes the shortcomings of past interventionist, directed and subsidized credit policies, which are very costly, do generally not achieve significant outreach and compromise the sustainability of poverty alleviation efforts. However, microfinance through government programs or poverty alleviation programs with microfinance components can still be needed instruments for target groups which can otherwise hardly be reached. Nevertheless, these programs need to be demand-driven, savings-focused and organized indirectly through appropriate microfinance institutions. The aim is to increase these target groups’ access to sustainable microfinance while at the same time further integrating microfinance in the formal financial sector.

5.4.2 Conducive Environment for Viable Microfinance

At the core of a microfinance system which addresses the needs of micro-entrepreneurs are viable and sustainable microfinance institutions. The Government of Indonesia shall set an appropriate legislative framework and, hence, create a space in which these institutions can operate and develop. The differing economic and social conditions of various target client groups impede a variety of microfinance institutions to serve their needs best. Over-regulation of both market entry barriers and interest rates shall be avoided in order to foster competition amongst microfinance services’ providers.

The scale of the country together with the ongoing decentralization process requires a clear division of tasks between the various Government institutions on central, provincial and district level regarding legal aspects, regulation and supervision as well as infrastructural and other support for the differing types of microfinance institutions and programs. This is particularly important in order to create synergies between the various Government interventions and to integrate institutional and program microfinance into one viable and demand-driven (micro-) financial system.

The main issue to be tackled here is the creation of a legal window for non-bank non-cooperative microfinance institutions which are allowed to accept deposits from the public within certain limits (geographical and threshold). Below a certain threshold (e.g. Rp200 million) institutions would be subject to non-prudential regulation only. Within a certain range above this lower threshold until a defined upper limit (e.g. Rp1,500 million) institutions would be prudentially regulated and supervised. Regulation, supervision and support for these second type is delegated to the provincial level.\(^{56}\)

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\(^{56}\) Problem of scale: a minimum capital entry requirement of Rp500m as it is currently prescribed for BPR implies an economically efficient total asset base of some Rp5b. For most rural-based MFIs, this size is not feasible because of lower population densities and larger areas to service. The figure of Rp1.5 billion was chosen as this would imply a capital of some Rp250 when CAR is set at 15%. Bearing in mind the proposed easing of requirements for BPR branching out, this could lead to bridging the existing demand-supply gap in rural areas.
5.4.3 Prudential Regulation and Effective Supervision

The overall aim of the Government of Indonesia’s commitment to prudential regulations is to protect small depositors as they are not in position to monitor the financial institutions’ soundness themselves. In addition, prudential regulation also serves the purpose to further develop an inclusive financial system with microfinance being an integral part of it, as it both ensures stability of the financial sector and improves the image of microfinance vis-à-vis the general public.

In principle, prudential regulation and supervision shall be applied whenever microfinance services’ providers raise retail deposits from the general public. This includes microfinance operations in commercial banks or finance companies. The Government of Indonesia shall promote cost-effective and efficient ways to regulate and supervise the microfinance sector in order to both protect small savers and create a level playing field among deposit-taking institutions.

The careful design of an appropriate supervisory system for different types of microfinance services’ providers through clearly designated and sufficiently equipped Government or other institutions is key for guaranteeing and maintaining the stability of the microfinance system.

5.4.4 Promotion of Microfinance

The Government of Indonesia takes on the responsibility not only to safeguard the stability and integrity of the microfinance sector but also to actively contribute to turning this industry into a catalyst for economic development. Hence, shall assume an active promotional role in human resource development and institutional capacity building as well as strengthening of financial infrastructure.

While recognizing the desirability of financially self-sufficient provision of human resource development and institutional capacity building in a long-term perspective, in the short and medium run smart subsidies may be necessary.

Another issue here is the creation of a permanent national institution or body in charge of promotion and research in the area of microfinance. This institution or body would also be in charge of monitoring and evaluating the microfinance development process and the implementation of the national microfinance policy and strategy.
APPENDIX A: The Yogyakarta Communiqué 2004

We, the Governors and Deputy Governors of Central Banks and high-level officials from Ministries of Finance and other authorities from 10 Asian countries present at the High-Level Policy Meeting on “Microfinance and Rural Finance in Asia” held in Yogyakarta from the 26th to 28th February 2004 identified appropriate strategies for Central Banks and Governments to promote Microfinance and Rural Finance.

Recognizing

- the co-existence of the conventional and the new paradigm in Microfinance and Rural Finance in many countries along a continuum between these different approaches,
- the longstanding and successful experience with commercially-oriented Micro-finance and Rural Finance in Asia, already providing millions of low-income households with financial services on a sustainable basis,
- the shortcomings of interventionist, directed and subsidized credit policies, which are very costly, do generally not achieve significant outreach and compromise the sustainability of poverty alleviation efforts,
- the imperative to focus our attention on poverty alleviation in order to meet the challenges arising from the Millennium Development Goals,
- the importance of market-based, effective Microfinance and Rural Finance Institutions for poverty alleviation,
- the need for a conducive regulatory framework for competitive Microfinance and Rural Finance Institutions to realize their potential outreach and impact on low-income households to effectively reduce poverty,
- the desirability of financially self-sufficient provision of institutional capacity building in the long run, while in the short and medium run smart subsidies may be necessary,
We, the Governors and Deputy Governors of Central Banks and high-level officials from Ministries of Finance and other authorities, will integrate Microfinance and Rural Finance as a powerful tool for poverty alleviation in development strategies of our countries and commit ourselves to apply in present and future actions the following principles of good practice:

1) We will work towards a conducive environment for commercially-oriented Microfinance and Rural Finance. The key issues to be addressed comprise liberalizing interest rates and enabling deposit-taking as well as non-collateralized lending to facilitate institutional sustainability, deregulating market entry barriers to foster competition, and providing appropriate mechanisms for exit of unsuccessful institutions.

2) We will work towards putting in place an appropriate regulatory and supervisory framework to enable an effective oversight on activities of microfinance institutions, in ensuring the adoption of best practices for microfinance and stability of the financial system.

3) We will promote cost-effective and efficient ways to regulate and supervise the Microfinance and Rural Finance sector to protect small savers and create a level playing field among deposit taking institutions.

4) We will strive for market orientation. We are aware that interest rate subsidies endanger institutional sustainability and undermine deposit mobilization. Only if markets clearly fail, temporary subsidies may be justified. Subsidies must be implemented transparently and phased out gradually.

5) We will assume an active promotional role in Human Resource Development and Institutional Capacity building.

6) We will extend the regional dialogue and co-operation among our countries to disseminate our rich and diverse experience with market-oriented and sustainable Microfinance and Rural Finance institutions, which are integrated in the formal financial sectors and serve large numbers of low-income households in Asia.

7) We will continue the dialogue commenced in Yogyakarta and discuss the critical issues presented today and the principles of good practice agreed upon today with stakeholders in our countries.

All participants welcome the excellent co-operation achieved at the High-Level Policy Meeting in Yogyakarta, in particular the progress of practical work in the countries represented and the constructive discussions that have taken place and the Central Bank and people of Indonesia for their gracious hospitality as well as GTZ and the German Government for their professional support and generous co-funding of the event.

Declared in Yogyakarta, 27th February 2004
APPENDIX B: Proposal for the Design of the new Non-Bank Non-Cooperative MFIs

<table>
<thead>
<tr>
<th>Features</th>
<th>BPR</th>
<th>Non-bank non-cooperative MFI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital</td>
<td>Rp2b, Rp1b, Rp500m for rural</td>
<td>Defined by savings</td>
</tr>
<tr>
<td>Deposit protection</td>
<td>yes: Rp100m cap</td>
<td>no deposit protection</td>
</tr>
<tr>
<td>Area of operations</td>
<td>provincial</td>
<td>district or adjacent district</td>
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<tr>
<td>Location of operations</td>
<td>urban or rural</td>
<td>rural</td>
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<tr>
<td>Kind of activities</td>
<td>As stipulated in Banking Act</td>
<td>same</td>
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<tr>
<td>Branches</td>
<td>yes</td>
<td>yes</td>
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<tr>
<td>Directors</td>
<td>2 at least</td>
<td>2 at least</td>
</tr>
<tr>
<td>Commissioner</td>
<td>1 at least, cannot be director</td>
<td>1 at least, cannot be director</td>
</tr>
<tr>
<td>Max. deposits</td>
<td>no limit</td>
<td>ceiling Rp1.5b; supervisor can increase</td>
</tr>
<tr>
<td>Prudential regime</td>
<td>full</td>
<td>nearly full</td>
</tr>
<tr>
<td>Ownership</td>
<td>no restriction</td>
<td>same</td>
</tr>
<tr>
<td>Legal entity</td>
<td>PT, PD, cooperative or Association</td>
<td>PT, PD, association, or legal entity created by the provincial government</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>PRUDENTIAL REGIME</th>
<th>BPR</th>
<th>Non-bank non-cooperative MFI</th>
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</thead>
<tbody>
<tr>
<td>Director’s Qualifications</td>
<td>Certification</td>
<td>Minimum Education Level, Minimum Experience</td>
</tr>
<tr>
<td>Capital entry requirements</td>
<td>rural: Rp500m</td>
<td>Defined by savings</td>
</tr>
<tr>
<td>CAR</td>
<td>8% to 12%</td>
<td>15%</td>
</tr>
<tr>
<td>Accounting chart</td>
<td>existing</td>
<td>BPR chart, simplified</td>
</tr>
<tr>
<td>CAMEL</td>
<td>existing</td>
<td>simplified: CAEL</td>
</tr>
<tr>
<td>LLL</td>
<td>10%, related aggregate 15%</td>
<td>5%; related not allowed</td>
</tr>
<tr>
<td>Asset quality</td>
<td>same loan classification and provisioning system</td>
<td></td>
</tr>
<tr>
<td>Reporting requirements</td>
<td>detailed, monthly</td>
<td>simplified, based on BPR, periodic (2 monthly or quarterly)</td>
</tr>
<tr>
<td>Costs of supervision</td>
<td>borne by BI</td>
<td>borne by Provincial Government</td>
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