Indonesian Microfinance at the Crossroads

Caught between Popular and Populist Policies

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ABOUT THE SERIES

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## Acronyms

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>BAPPENAS</td>
<td><em>Badan Perencanaan Pembangunan Nasional</em>, the National Development Planning Agency.</td>
</tr>
<tr>
<td>BI</td>
<td><em>Bank Indonesia</em>, the central bank of Indonesia</td>
</tr>
<tr>
<td>Bimas</td>
<td><em>Bimbingan Massal</em> (mass guidance), a rice intensification program with a subsidized credit component.</td>
</tr>
<tr>
<td>BKD</td>
<td><em>Badan Kredit Desa</em> (village banks), consisting of <em>Lumbung Desa</em> (paddy banks) and <em>Bank Desa</em> (village banks), MFIs originating in the Dutch colonial time and still operating in Java and Madura; they have been awarded a BPR license.</td>
</tr>
<tr>
<td>BK3D</td>
<td><em>Badan Koordinasi Koperasi Kredit Daerah</em>, a regional/local level apex body of credit unions.</td>
</tr>
<tr>
<td>BKK</td>
<td><em>Badan Kredit Kecamatan</em>, sub-district level MFIs founded by the Provincial Government of Central Java in the 1970s.</td>
</tr>
<tr>
<td>BLT</td>
<td><em>Bantuan Langsung Tunai</em>, direct cash grants to poor families to compensate for the abolition of the oil subsidy.</td>
</tr>
<tr>
<td>BMT</td>
<td><em>Baitul Maal wat Tamwil</em> (integrated business house), MFIs founded by local Muslim communities that practice <em>shariah</em> finance. Most assume a cooperative form.</td>
</tr>
<tr>
<td>BPD</td>
<td><em>Bank Pembangunan Daerah</em>, provincial development banks owned by provincial governments; their legal form is now that of commercial banks.</td>
</tr>
<tr>
<td>BPR</td>
<td><em>Bank Perkreditan Rakyat</em> (rural banks), people’s credit banks, second-tier banks to serve small business and lower income groups.</td>
</tr>
<tr>
<td>CAMEL</td>
<td>C=capital adequacy, A=assets quality, M=management, E=earnings, L=liquidity: a set of criteria to assess the performance of commercial banks, later to be adapted for BPRs.</td>
</tr>
<tr>
<td>DSP</td>
<td><em>Danamon Simpan Pinjam</em>, savings and loan units of Bank Danamon, a private commercial bank.</td>
</tr>
<tr>
<td>FIDP</td>
<td><em>Financial Institutional Development Project</em>, a project funded by USAID, 1985-1993, to promote the development of rural financial institutions in 10 provinces and BRI Units.</td>
</tr>
<tr>
<td>HIID</td>
<td>Harvard Institute for International Development, an advisory team assisting the Indonesian government in the 1980s.</td>
</tr>
<tr>
<td>Inkopdit</td>
<td><em>Induk Koperasi Kredit Indonesia</em> (Indonesian Credit Unions League), a national apex body of credit unions in Indonesia.</td>
</tr>
<tr>
<td>KUD</td>
<td><em>Koperasi Unit Desa</em>, multipurpose village cooperatives supported by the government.</td>
</tr>
</tbody>
</table>
KUK | Kredit Usaha Kecil (small business credit), loans to small enterprises and cooperatives to fulfill banks' credit quota of 20% of loan portfolio.
Kupedes | Kredit Umum Pedesaan, general-purpose rural loan scheme of BRI Units.
KUT | Kredit Usaha Tani, subsidized farming credit succeeding Bimas.
LDKP | Lembaga Dana dan Kredit Pedesaan, a generic name to cover all village and sub-district level MFIs founded by district/provincial governments before the enactment of the 1992 Banking Act.
LPS | Lembaga Penjamin Simpanan, Deposit Guarantee Office.
MSME | Micro, Small, and Medium Enterprises, same as UMKM.
Simpedes | Simpanan Pedesaan, the rural savings scheme of BRI Units.
TPSP-KUD | Tempat Pelayanan Simpan-Pinjam – KUD, savings and lending service points of KUDs.
UED-SP | Unit Ekonomi Desa-Simpan Pinjam, MFIs founded by the Ministry of Home Affairs.
UMKM | Usaha Mikro, Kecil, dan Menengah, micro-small-medium enterprises (MSME).

Introduction

DESPITE THE PRESENCE of various microfinance institutions (MFIs) in Indonesia, some of which follow international best practices, the country's credit policy is dominated by a stream of subsidized credit programs. Little attention has been paid to sustainable commercial models as practiced by many local or community-based MFIs,\(^1\) which were behind the success of BRI Unit, the largest MFI in the world. These local MFIs have been left to pave their own path, far from the attention of the government, which is always busy with its populist programs: from alleviating poverty, to developing small-scale enterprise and village cooperatives, to revitalizing agriculture. Despite the influence of microfinance from the outside world – which led to Indonesia's participation in the International Year of Microcredit 2005 – the old paradigm remains in the mindset of policy makers, even as the country is experiencing severe budget constraints.

Formal and Informal Microfinance in Indonesia\(^2\)

A variety of old and new MFIs exist in Indonesia, including: (1) BRI Units; (2) BPRs (rural banks, smallholder credit banks),

\(^1\) See Uphoff, 1986. "Local level" is most often equated with community level, but it may cover a set of communities as large as the sub-district level. "Local MFIs" are defined here to include all MFIs founded before the enactment of banking deregulation in October 1988 (Pakto 88), when the government first permitted the establishment of new rural banks (BPRs). These local MFIs include BKDs, market banks, employee banks, other village banks, and LDKPs. Local MFIs are also known as the "old BPRs,” while those founded after October 1988 are referred to as the "new BPRs.”

\(^2\) See list of acronyms at the beginning of this document.
consisting of BKDs (village banks) and non-BKDs (“new” BPRs and old MFIs that have converted to BPR status); (3) non-bank non-cooperative MFIs (LDKPs, sub-district and village-level MFIs founded by provincial/district governments); (4) cooperatives (credit cooperatives and saving and loan units, including credit unions and BMTs); (5) Grameen Bank replicators (mostly unlicensed), and some NGOs (most of which have a foundation license). As of mid-2005, there were over 54,000 outlets for microfinance\(^3\) (Table 1), serving over 29 million borrowers (13% of the population) and more than 43 million depositors (19% of the population).

Table 1. Microfinance Institutions in Indonesia

<table>
<thead>
<tr>
<th>TYPE</th>
<th>UNITS/OFFICES</th>
<th>BORROWERS</th>
<th>OUTSTANDING LOANS</th>
<th>DEPOSITORS</th>
<th>DEPOSITS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>'000s</td>
<td>%</td>
<td>(USD m) %</td>
<td>'000s</td>
</tr>
<tr>
<td>Comm.Banks' Micro-loans, (June 2005)</td>
<td>8,069</td>
<td>14.9</td>
<td>14,271</td>
<td>48.0</td>
<td>14,036</td>
</tr>
<tr>
<td>- BRI Units (April 2005)</td>
<td>4,046</td>
<td>7.4</td>
<td>3,211</td>
<td>10.8</td>
<td>2,134</td>
</tr>
<tr>
<td>Rural Banks (BPR):</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- BKDs (June 2005)</td>
<td>4,482</td>
<td>8.3</td>
<td>395</td>
<td>1.3</td>
<td>21</td>
</tr>
<tr>
<td>- Non-BKD (June 2005)</td>
<td>2,062</td>
<td>3.8</td>
<td>2,331</td>
<td>7.8</td>
<td>1380</td>
</tr>
<tr>
<td>Non-Bank Non-Coop (LDKPs) (July 2004)</td>
<td>1,620</td>
<td>3.0</td>
<td>1,326</td>
<td>4.4</td>
<td>45</td>
</tr>
<tr>
<td>- BKK (Dec.2004)</td>
<td>160</td>
<td>0.3</td>
<td>143.</td>
<td>0.5</td>
<td>26</td>
</tr>
<tr>
<td>Credit Coop (Dec. 2004)</td>
<td>1,596</td>
<td>2.9</td>
<td>885</td>
<td>3.0</td>
<td>116</td>
</tr>
<tr>
<td>- Credit Unions (Dec. 2004)</td>
<td>1,041</td>
<td>1.9</td>
<td>n.a.</td>
<td>n.a.</td>
<td>958</td>
</tr>
<tr>
<td>S &amp; L Units (Dec. 2004)</td>
<td>36,466</td>
<td>67.1</td>
<td>10,524</td>
<td>35.4</td>
<td>1,349</td>
</tr>
<tr>
<td>- BMT (July 2004)</td>
<td>3,038</td>
<td>5.6</td>
<td>1,200</td>
<td>4.0</td>
<td>20</td>
</tr>
<tr>
<td>Grameen Bank Replicators</td>
<td>21</td>
<td>0</td>
<td>20</td>
<td>0.1</td>
<td>0.52</td>
</tr>
<tr>
<td>TOTAL</td>
<td>54,317</td>
<td>100</td>
<td>29,752</td>
<td>100</td>
<td>16,948</td>
</tr>
</tbody>
</table>

Sources:
Bank Indonesia- Bureau of Credit, Sept. 2005, Bank Indonesia –Directorate for BPR Supervision, 30 June 2005,
Bank Rakyat Indonesia, 2005 (report to BI), Bank Pembangunan Daerah Central Java, Dec. 2004

\(^3\) This number includes commercial bank offices.
Bank Indonesia (BI) is encouraging commercial banks to lend to micro-small-medium enterprises (MSME) through self-determined targets in their business plans. BI has also defined micro-credit broadly to include loans up to Rp50 million (approx. USD 5,450). Under this broad definition, commercial banks dominate “micro-credit”, serving 48% of total borrowers with loans totaling 82.8% of the aggregate outstanding microfinance loan portfolio. BRI Units, which number nearly half of total commercial banks’ outlets, account for 10.8% of borrowers and 12.6% of outstanding micro-loans. The average micro-loan size of commercial banks is USD 983.50 (around 85% of income per capita), as compared to USD 53 for BKDs (approximately 5% of per capita income).

On the deposit side, leaving out non-BRI commercial banks due to lack of data on micro-savings, BRI Units dominate the market, providing services to 72% of depositors and accumulating 68.8% of the total value of micro-deposits. Non-BKD rural banks are ranked second with 13.5% of depositors and 25.5% of total deposits. Most of the deposits of BKDs, LDKPs, and coops consist of mandatory savings.

The only MFI providing insurance is Inkopdit, the national apex of credit unions, which provides nationwide insurance. In addition to this nationwide insurance, some regional apexes also provide local-level insurance schemes.

Most MFIs are located in western Indonesia, especially Java and Bali; very few operate in the eastern provinces.

In addition to MFIs, state pawnshops provide pawning services through 797 branch offices, currently lending to 10.75 million customers a total amount of Rp7.6 trillion (approximately USD 830 million) or about USD 77 on average. Pawnshops have competed with moneylenders since colonial times, and their proud slogan reads: “Solving problems without creating other problems.”

Within the informal sector, a traditional MFI found throughout the country is the arisan, the Indonesian rotating savings and credit association (ROSCA). The number of arisans is estimated to be in the millions. Many people join more than one arisan for economic and social purposes, while others manage arisans as a side job. In rural areas, traders offer loans against standing crops through the tebasan and ijon systems. Even smaller loans called mindring are provided by retail traders of clothes or household utensils. Farmers also commonly get in-kind loans of rice and farm inputs from traders or shopkeepers at prices higher than cash prices. Commercial moneylenders are also still operating in rural areas and catering to the short-term needs of the poorest, although they are not flourishing as in the past. Some moneylenders are disguising their activities under the name of cooperatives.
Subsidized Loan Programs and Banking Reforms

Subsidized loan programs began in 1972 as a component of a comprehensive rice intensification program called Bimas (Bimbingan Massal or Mass Guidance). Bimas started as a pilot project in 1964 that also prescribed the formation of BUUD/KUDs (village unit cooperatives) and BRI Unit Desa (village unit of BRI) as conduits for supplying production inputs and extending credit, respectively. Bimas for rice was soon followed by Bimas for secondary crops and other commodities: sugarcane (TRI), cotton (IKR), fisheries (ITR), as well as for agriculture-related projects such as rice milling units, hand tractors, food stock procurement, and many others. To support small-scale entrepreneurs, the government launched credit programs for investment and working capital financing called KIK and KMKP. For the micro segment, the Ministry of Finance introduced Kredit Mini and Kredit Midi (both channeled through BRI Unit Desas), and Kredit Candak Kulak, which was channeled through KUDs. Eventually, a branch office of BRI could manage up to 116 different loan programs. Indonesia was successful in achieving self-sufficiency in rice production in 1984, but this achievement came at the expense of huge bad debts and damage to the Unit Desas' financial conditions and morale.

In June 1983, the first banking reform was enacted, which abolished restrictions on interest rates and ceilings on credit expansion. In October 1988, a decline in oil revenue led to the enactment of the next banking reform, Pakto 88, which liberalized rules governing the establishment of new banks as well as new branch offices of the existing banks to tap domestic savings and to expand loan facilities. These two successive reforms succeeded in boosting not only the number of bank offices but also savings mobilization and credit expansion at remarkable rates that had never been achieved before.

The next step in the reforms, Pakjan 1990, took place in January 1990. Pakjan 1990 was intended to gradually reduce subsidized Central Bank credit, leaving only those preserving self-sufficiency of rice production, procuring food stock, assisting the development of cooperatives, and boosting investment in the eastern part of Indonesia. At the same time, Pakjan 1990 also required commercial banks to lend at least 20% of their portfolios to small-scale businesses (KUK).

In retrospect, BI was not fully successful in reducing the amount of subsidized financing due to pressure from the government, especially some ministries that were noted as long-time promoters of subsidized credits. Outside the banking sector, before the 1997 financial crisis, the rural population was supplied with some forms of cheap credits by certain government institutions, such as: (i) IDT (President Instruction for Backward Villages), provided by BAPPENAS (National Development Planning Agency); (ii) Kukesra (credit for family welfare), provided by the Ministry for Population and Welfare; and (iii) credit for small enterprises and economically weak groups from

7 Chavez & Gonzales-Vega, 1993.
8 Previously, the government had relied heavily on oil revenues to support development projects. The end of the oil bonanza led to banking deregulation, with the goal of establishing new banks and branch offices to tap domestic savings and domestic financing for (private) development projects.
9 As noted in footnote 4 above, the KUK was abolished in 2001.
the state enterprises' profit (as ordered through a Ministry of Finance decree).

As a result of the 1997 monetary crisis, subsidization has returned to the mainstream. The government implemented a large number of new loan programs and other social safety net-type schemes, crowding the market with cheap and uncontrolled credits. A new KUT (subsidized farming credit program) was launched after the original KUT was informally suspended due to high arrearage of participating village cooperatives (KUDs). The new KUT was supposed to eliminate the weaknesses of the former KUT by allowing NGOs to participate as another loan channel. However, this KUT scheme has repeated exactly the same sad stories, but with NGOs as the new defaulters.

The Banking Reforms and Microfinance Development: Stage One

It is commonly believed that the Indonesian banking reforms of 1983 that lifted the restriction on interest rates led the way to BRI Unit’s success through the launch of its commercial Kupedes and Simpedes schemes. The real impetus, however, was the termination of Bimas succeeded by the KUT (another subsidized credit scheme) in 1984. Under the KUT, the Unit Desa no longer functioned as a credit conduit because it was replaced by KUDs (village cooperatives), which were touted as “the pillar of the village economy.” Facing the dilemma of dissolving 3,626 Unit Desa or putting in the necessary effort to ensure their survival, the BRI management had no other choice but to half-heartedly take the advice of an advisory team from HIID that was assisting the Ministry of Finance to convert the Unit Desas into commercial banking units. The success of the Kupedes at the first stage was seen as a miracle, even by the BRI management who had been taught about the evils of subsidized loan programs.

Despite the success of BRI Unit and other positive results from the banking reforms (including increases in number of banks, savings mobilization, lending, etc.), the enactment of the Banking Act of 1992 had some negative consequences. While the 1967 Banking Act acknowledged the existence of all traditional MFIs (paddy banks, village banks, market banks, and other ‘secondary banks’) and allowed them to operate within the banking system, the 1992 Banking Act perceived many of these MFIs as ‘weak’ and ‘small’ and required them to upgrade to rural bank (BPR) status. After becoming BPRs, they had to comply with the CAMEL performance rating, standardized reporting requirements, the obligation to open for business daily, and other regulations applied to commercial banks. These requirements undermined the performance of these MFIs as local economic institutions, as they required drastic changes to their accounting system, organization, cost structures, and work cultures. The application of the CAMEL rating discouraged the broadening and deepening of outreach.

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12 Interview with the late Sugianto, BRI’s director.
The 5,345 village banks (BKDs) were exempted from these requirements for an indefinite time period. It was estimated that compliance would bankrupt 90% of them.\textsuperscript{13} Enforcement of the conversion requirement consigned another 2,272 MFIs in 10 provinces to ‘illegal’ status and a bleak future. A study of 510 sub-district MFIs (BKKs) in Central Java indicated that adherence to CAMEL led these MFIs to suffer from a decline in existing and new borrowers, and a shift in market segment towards higher-income groups. Unlike their previous classification criteria, factors that were crucial for measuring outreach – such as number of new borrowers, loan disbursements, savings mobilization, and the number of village posts – were no longer considered in the CAMEL rating.\textsuperscript{14}

A New Understanding of Microfinance

A new understanding of microfinance began to spread in 1999 and culminated in 2000 with the formation of a forum named “Gema PKM” (The Movement for Microfinance Development), which included representatives of government agencies that had previously promoted subsidization programs. In response to the demand for microfinance regulation that emerged from the forum, BI keenly initiated the drafting of a Microfinance Bill by organizing an Initiative Team in late 2000. This draft was passed on to the Ministry of Finance in 2001, which delivered it to the State Secretariat, but there was no sign that the draft had been passed on to the Parliament. It was said that the State Secretariat did not see any urgency to pursue the draft, and there were many other important drafts waiting in the pipeline. To continue to advocate for the ideas behind the abortive draft, Pro-Fi – BI’s microfinance advisory team – disseminated in 2003 a ‘blue book’ on the development of microfinance. The blue book advised the government to lift all constraints on microfinance and to set up policies conducive to the development of microfinance, including: (i) phasing out subsidized loan programs; and (ii) legalizing non-bank-non-cooperative MFIs and allowing them to mobilize savings in a limited area and up to a certain threshold. A similar message was declared in “The Yogyakarta Communique” by high officials of Central Banks and Ministries of Finance of ten Asian countries when they convened in Indonesia in February 2004. The communique included an agreement to gradually shift from subsidized and directed microfinance towards a new paradigm of commercial micro and rural finance.

While BI’s attention to BKDs has been limited only to publication of statistics and the provision of funds to BRI to supervise them, it has done much to improve the performance of the licensed BPRs. One big step has been to include BPRs in the National Deposit Guarantee Scheme (LPS). Furthermore, in response to a request from an association of private BPRs (PERBARINDO) to set up an “apex bank” to function as a pool of funds for inter-lending among BPRs, BI launched a pilot project in the form of a cooperative-like apex in Central Java. This apex is somewhat

\textsuperscript{13} Martowijoyo, 2001.

\textsuperscript{14} Martowijoyo, ibid.
more limited in scope as compared to the generally known apex concept, especially in terms of activities and coverage. The apex aims to pool funds for lending and to act as a kind of clearing-house, and it caters solely to the needs of BPRs – formal MFIs that legally have access to external funding sources (linkages to commercial banks) and other facilities, such as supervision, technical assistance, and deposit guarantee from the authorities – and not to the majority of MFIs, which are badly in need of such assistance.

A Longer Breath for BKDs

The transfer of banking supervisory authority from BI to a new financial supervisory body, which was supposed to be done by 2002, has been postponed until 2010 by the Parliament. As a result, BI still retains both regulatory and supervisory duties for all licensed banks. To reduce its supervisory burden, BI is still financing BRI to perform the supervision of village banks (BKDs) on its behalf. Based on the philosophy of “the bigger, the stronger,” which is followed by the Central Bank, the BKDs are not rural banks that fit its BPR concept, so it has focused almost all of its attention on the “new” BPRs rather than the BKDs. Nevertheless, some authors have pointed out the advantages of this traditional MFI type: BKDs have been tactfully using “social mechanisms” in their lending and have the deepest outreach among prominent MFIs worldwide (see Table 2).

Today, BRI’s treatment of BKDs is not more than that of a contracted auditor, because the Staatsblad No. 357 of 1929, in which a patron-client relationship between BRI and BKDs was established, was revoked by the Banking Act of 1992.

The extension of BI supervisory authority has given BKDs until 2010 to prepare before becoming an ‘orphan,’ because the new supervisory body will likely require them to comply with its regulations and will charge a supervision fee. Nevertheless, less attention from BI and BRI has already affected the sustainability of BKDs, as witnessed by the decrease in the number of active BKDs year by year. Out of 5,345 listed BKDs, the number of active ones has been declining from 4,806 in 1999 to 4,482 in 2005, an average of 54 units per year. It is difficult to attract attention from international donors, because they are mostly interested in the “modern” institutions, such as BRI Units, Grameen Bank replicators, or FINCA’s model of village banking; traditional village banking like that practiced by BKDs has never been on their list. Governments and international donor agencies perceive local indigenous institutions as “very weak”, and they prefer to work with “modern” institutions that are assigned to do the same tasks.

15 See Chavez & Gonzales-Vega, 1996. “Social mechanisms” refers to using the influence of the village heads to assist with loan screening and repayment.

16 Christen et al., 1995. While the numbers are 14 years old, BKDs continue to be worldwide leaders with respect to depth of outreach today.

17 According to the Staatsblad, BRI was tasked with providing BKDs with financial and technical assistance in addition to supervisory oversight.

18 Without BRI and BI, BKDs will be losing technical and financial support.


20 With greater oversight and technical assistance, most BKDs have the potential to become financially viable. In fact, there were two projects patterned after the BKDs, although BKDs were not explicitly mentioned: UED-SP from the Ministry of Home Affairs, and TPSP-KUD from the Ministry of Cooperatives. However, the government, BI, and BRI have never exposed BKDs to major donors in international forums. This stems largely from a bias among both government and foreign donors against local indigenous institutions. For more on this bias, see Uphoff, 1986.
Table 2. The Depth of Outreach of Prominent MFIs, 1993.

<table>
<thead>
<tr>
<th>MFI</th>
<th>AVERAGE LOAN AMOUNTS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>USD</td>
</tr>
<tr>
<td>1. BKD (Indonesia)</td>
<td>38</td>
</tr>
<tr>
<td>2. LPD (Indonesia)</td>
<td>130</td>
</tr>
<tr>
<td>3. Actuar/CorpoSol (Columbia)</td>
<td>366</td>
</tr>
<tr>
<td>4. BRI Unit (Indonesia)</td>
<td>494</td>
</tr>
<tr>
<td>5. BancoSol (Bolivia)</td>
<td>535</td>
</tr>
<tr>
<td>6. ACEP (Senegal)</td>
<td>1,016</td>
</tr>
</tbody>
</table>

Source: Christen et al., 1995, Appendix B.

The Banking Reforms and Microfinance Development: Stage Two

While BKDs serendipitously benefit from a longer period of supervision before facing an unclear future, further implementation of the BPR system has drastically affected BKKs, the sub-district level MFIs in Central Java, which were also previously affected by the change in performance criteria and reporting requirements in the early 1990s.

The simple organizational structure of BKKs that had been adopted at their inception in the 1970s, consisting of a manager plus three officers, was required by the provincial government to be changed completely into a modern BPR model patterned after commercial banking. At the top of the new structure is the Board of Supervisors, followed by a Board of Directors consisting of two persons overseeing from three tiers of staff (for C-type BKKs) to seven or more tiers of staff (for A-type BKKs). As a result, each BKK now must be staffed by 10 to 17 persons. The classification is based on total assets: type A BKKs have total assets of over Rp15 billion (approx. USD 1.6 million), type B BKKs have over Rp5 billion (approx. USD 545,000) but no more than Rp15 billion, and type C BKKs have up to Rp5 billion.21

Furthermore, to meet minimum capital requirements, and to reduce the number of institutions (in accordance with another popular prescription for the banking sector), BKKs have been undergoing a process of merger aimed at leaving only one

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licensed BKK in each district. The healthiest licensed BKK in a district will be chosen as the head office. All other BKKs in the same district will be reclassified as branch offices of this BKK. The remaining 160 unlicensed BKKs throughout Central Java are being upgraded to qualify for at least C-class branch office status. As of December 2005, there had been mergers in 9 districts, reducing the total number of licensed BKKs from 349 to 313.22

The doubling and tripling of the number of staff per BKK – from originally 5 persons (including a night-guard) – will drastically increase overhead costs, thereby reducing efficiency and limiting opportunity for self-sufficiency. In addition, there is a significant psychological impact on the BKK staff, the majority of whom suffer degradation in status when their BKKs are demoted to branch offices. 23

Enforcement of BPR rules has also led to the termination of a 35-year paternalistic apex relationship between the Central Java provincial development bank (BPD) and the BKKs. As a BKK has to become a licensed rural bank (BPR), the BKK’s supervisor at the BPD’s branch office will no longer be allowed to audit it, since this authority has shifted to the Board of Supervisors, which is led by the head of a district or the mayor of a municipality. Licensed BKKs also are not free to invest their liquidity in the BPD, because such a placement is now subject to legal lending limits for related parties. For these reasons, the BPD is seriously considering selling its ownership shares in BKKs.

It is ironic that despite its limited resources, the Central Bank responded promptly to the demand for a limited apex function for a group of rural bank (BPRs), while at the same time destroying a good example of a long-standing apex through application of a new regulation. Assisted by the USAID-funded Financial Institutions Development Project (FIDP) from 1985 to 1993, the Central Java BPD has properly functioned as a complete apex for BKKs: regulating, supervising, training, and funding. Its monthly report on BKKs provided comprehensive data needed by any microfinance researcher, including data categorized by borrower, by gender, and by loan amounts. It is a pity that all of these advantages will soon disappear, to be replaced by the “modern” BPR model.

The Reformation Era: Return to Populist Policies?

Among the few good things resulting from the “reformation” era following the fall of President Suharto was the abolition of the KUDs’ monopoly as the only permitted cooperative in the sub-districts. This abolition has paved the way for credit unions and BMTs (Islamic MFIs) to be included in the cooperative family.

The number of cooperatives and their members have increased dramatically due to the new policy. Based on a report from the Ministry of Cooperatives, the number of cooperatives had reached 38,062 with 11.4 million members (as of December 441x648 22 Interview with Adi Widayat, Central Java BPD.

23 A minority of BKK staff who are chosen as head office staff get an increase in status and salary, due to the equal-opportunity recruitment of the head offices’ staff members from all existing BKKs’ staff, using objective criteria and a “fit and proper” test.

24 State Ministry of Coop & SME, 2005.

The number of credit unions had reached 1,041, and BMTs had increased from 1,982 in December 1998 to 3,038 as of July 2004. On the other hand, the status of the Ministry of Cooperatives has been reduced to a state ministry. This means that it has lost its provincial- and district-level offices, which has resulted in less intensive supervision. In terms of loan policy, although the government has changed three times since Suharto, all Ministers of Cooperatives seem to follow the same old paradigm of subsidized loan programs.

The President Susilo Bambang Yudhoyono declared the Revitalization of Agriculture in June 2005, but there was no real action taken until the following year. In July 2006, the Coordinating Ministry of Economic Affairs announced that to boost the development of agricultural estates – especially palm oil, rubber, and cacao – the government was going to subsidize lending rates. These rates were around 16% p.a. at that time, and the government intends to enable a consortium of banks, led by BRI, to lend at 10% p.a. The following month, the Ministry of Sea Affairs and Fisheries declared that a guarantee fund would be placed with BRI and three Provincial Development Banks (BPDs) to get them to onlend four times that amount to the fisheries sub-sector at 6% p.a. – 3% of which will be retained for the banks, and the remaining 3% of which will be refunded to the borrowers upon on-time repayment.

While oil subsidies have been terminated, the government is disbursing subsidies directly to poor people in the forms of (i) cheap rice at Rp1,000 per kg (approx. USD 0.11), while the average market price is around Rp3,500 (approx. USD 0.38); and (ii) a “direct cash aid” (BLT) of Rp100,000 (approx. USD11) per poor family per month, as compensation for oil price increases. As the number of poor people has increased drastically due to natural disasters and oil price hikes, the government is desperately seeking funds for these new subsidies.

It is clear that the old paradigm of subsidized loan programs has never ceased and is being revived. A second generation of subsidized agricultural loan programs is taking place, three decades after Bimas in the 1970s. The performance of these new programs is difficult to predict, considering that the current banking atmosphere is very different from that of the 1970s. During that time, the banking sector was labeled the “agents of development” and spoiled with cheap liquidity funding from the Central Bank to finance all subsidized loan programs. The government had plenty of money from the windfall profits due to the oil bonanza. After the happy years ended, however, several stages of banking deregulation were enacted, until the banking sector collapsed when hit by the monetary crisis in 1997-1999.

The reconstruction process from the crisis has not yet enabled the remaining banks or the real sector to fully recover. The Central Bank Act of 1999 has prevented the BI from lending directly or providing liquidity funds to the government or the banking sector. Sluggish lending and high non-performing loans within the banking sector reflect the condition of the economy.
through 2006. This situation might worsen, as the Attorney General treats bad debts of the state banks strictly. Due to economic stagnation and the government’s failure to create a conducive environment for the real sector, some in the Parliament are proposing an amendment to the BI Law to revert to its role in the past: as the provider of liquidity funds for the banking sector.\textsuperscript{30} A complete return to the policies of the Bimas era may soon occur!

\textsuperscript{30} Kompas, 18\textsuperscript{th} January 2007.

Conclusion

The Indonesian government’s understanding of microfinance has been limited to just a glimpse at the International Year of Microcredit 2005. There have been neither policy nor real-sector actions taken to develop microfinance. On the contrary, the pressure for implementing subsidized loan programs is getting stronger. In the years to come, it will be interesting to watch how the participating commercial banks cope with the problem of disbursing subsidized loans vis-à-vis their need to lend cautiously in an effort to keep down non-performing loans.

BI, which has had experience in managing microfinance projects, is acting tactically for the banking sector by defining micro-credit to include loans up to Rp50 million. Its policy has created more confusion regarding the role of microfinance as a means for poverty alleviation, and it has diverted attention from the importance of real pro-poor microfinance. The enforcement of the BPR system with respect to the existing traditional MFI s – such as village banks (BKDs) and non-bank non-cooperative MFI s (LDKPs) – has left them with an unclear status and a bleak future. In the second stage, the decision of the Central Bank to follow popular policy prescriptions has resulted in the destruction of the original BKK system and the termination of the BKKs’ long-time apex relationship with the Central Java BPD.

Microfinance in Indonesia is trapped at a crossroads of two unsupportive and contradictory policies: the enforcement of the BPR system by the Central Bank, which requires a complete transformation of the nature and culture of the original system; and the forthcoming waves of subsidized loan programs from the government that will crowd out the market with cheap credits. Either road will badly threaten the sustainability of commercial microfinance. If BKDs and LDKPs are still surviving ten years from now, that would be the real triumph of microfinance.
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