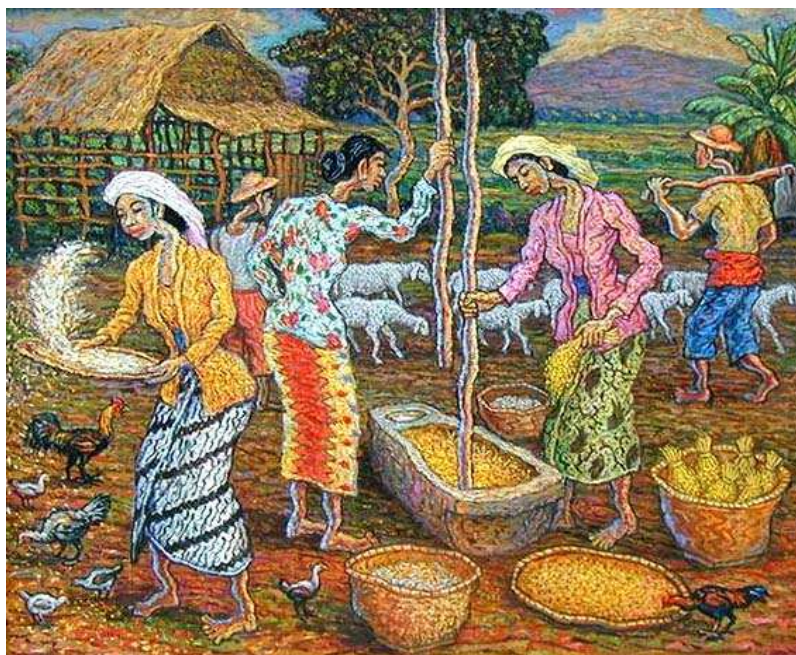


MICROFINANCE COUNTRY OVERVIEW

INDONESIA



PREPARED FOR MICRONED

BY

**DELIMA KISWANTI
HERMAN ABELS**

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TABLE OF CONTENTS

	EXECUTIVE SUMMARY	3
1.	COUNTRY INFORMATION INDONESIA	5
1.1	Overview	5
1.2	Macro-economic Situation and Indicators	7
1.3	Social Issues	8
2.	THE FINANCIAL SECTOR	11
2.1	General Overview	11
2.2	Demand for Microfinance	12
2.3	The Finance Gap	13
2.4	The Emergence of MFIs	14
2.5	Current MFIs	16
2.6	Targeted and Informal Microfinance	18
2.7	Products and Pricing	19
3.	TRENDS AND ISSUES IN MICROFINANCE	21
3.1	Market Trends	21
3.2	Regulation	22
3.3	Institutional Quality and Competencies	24
3.4	Outreach	25
4.	MICRONED MEMBERS AND OTHER DONORS	27
4.1	Investment Overview	27
4.2	Other Donors, Investors and Service Providers	28
5.	FUTURE LOOKING STRATEGIES	31
5.1	Conceptual Considerations	31
5.2	For-Profit MSME Lending	32
5.3	Civic Sector Microfinance	33
5.4	Mutual Microfinance	34
5.5	The Need for Interfaces	34
5.6	Beyond Microfinance	35
Annex 1	Relevant Legal Considerations	37
Annex 2	The Patchwork of Acronyms	39
Annex 3	Persons Consulted	40
Annex 4	Resources	41

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EXECUTIVE SUMMARY

1. Indonesia has a large and highly diverse microfinance market with well-developed private, public and mutual sub-sectors and a considerably smaller civic sub-sector. Overall some 33 million people borrow from financial institutions whereas 47 million place their savings and deposits there. Reaching the bulk of the borrowers are supervised village banks, savings and deposit units of multi-purpose cooperatives, the microfinance division of BRI and the many People's Credit Bank (BPRs). Savings are mostly collected through commercial banks and predominantly through BRI.¹

2. Whereas these overall outreach figures are impressive, it must be realized that not all loans can be categorized as micro loans. Industry data are based on the concept that microfinance covers loans to micro, small and medium entrepreneurs (MSMEs) which does not allow for accurate analysis of data as regards categories of clients. What is clear nonetheless is that there is a double specific service gap: the rural sector is relatively moderately served in Java and Bali whereas in Eastern Indonesia there is a more overall service gap.

3. This is widely attributed to the lower levels of involvement of non-profit civic institutions such as NGOs in Indonesian microfinance. Reasons for that are manifold: a regulatory environment that favors for-profit service delivery, additional legal obstacles for foundations to fully engage in economic activities, a long standing tradition of public sector involvement by way of including subsidized credit components in development programs and widely-felt human resources and institutional capacity challenges. The mutual or cooperative sector is also plagued by these challenges and has noticeably given in on its member-based rationale. Efforts to create a Non-Bank Non Coop (NBNC) regulatory slot have failed, which does not really facilitate other Asian non-profit MFIs becoming operational in the country.

4. Indonesian microfinance is essentially a home-grown industry that attracts very little off-shore capital, partially because of high liquidity levels in the domestic capital market but also because the lowest tier of the banking sector (the BPRs) is prohibited from attracting foreign capital as well as from foreign (co-)ownership. There are interesting examples of institutions that have successfully worked around these obstacles but their number is quite limited as yet and it remains doubtful if these examples could be replicated at any scale.

5. Because Indonesian microfinance is largely urban-based and focused on small entrepreneurs, it does not have a strong tradition of group-based delivery formats. Service provision is largely individualized and relatively expensive with standard loan products carrying average tenures of two to three months and costing 2 to 5% interest per month at a national inflation level of approximately 6% per annum. The upside of this is that service delivery is highly responsive to clients' actual financial needs and not subject to time-consuming group meetings and articulate graduation schemes.

6. MicroNed members Cordaid, Hivos, ICCO and Oxfam Novib are all actively supporting the further development of Indonesian microfinance with a wide variety of activities working together with 18 institutions in the private, mutual and civic sub-

¹ Under Indonesian regulation the commercial bank category captures all Tier 1 banks, including private, public, syariah and foreign banks.

sectors throughout the archipelago. Although the overall volume of grants and loans is quite limited, relative to the size of the industry, with a combined portfolio of approximately EUR 2.3 million for both grants and loans each over the period 1999-2006, it nonetheless constitutes a considerable part of overall foreign donor contributions and investments.

7. In terms of future contributions, MicroNed members can consider various options beyond continuation of the current pattern of support. There is large demand for strengthening rural capacity as well as overall capacity in Eastern Indonesia. A major obstacle is the relatively limited absorption capacity due to major institutional and human resource constraints in both realms, in some cases compounded with a lack of entry level capital to finance loan portfolios. These gaps can be narrowed by further building one-on-one donor-MFI partnerships (micro level) but also through strengthening service capacity at the meso level of the industry. On top of that there is a continued need for strengthening the handling capacity of MFIs more active in the urban MSME market. At macro level there do not appear to be specific opportunities for intervention at this point in time, even though a main challenge remains in the form of the absence of a NBNC regulatory slot. Such opportunities could reemerge in the coming years, for instance in conjunction with the anticipated Indonesian hosting of the MicroCredit Summit Campaign for the Asia-Pacific region.

1. COUNTRY INFORMATION INDONESIA

1.1 Overview



Population	225,300,000 (UN, 2005)
Land size	1,900,000 square KM
Languages	Bahasa Indonesia and 300 regional languages
Life expectancy	65 years for men; 69 years for women (UN)
Monitory unit	Rupiah (IDR 14,000 = EUR 1; Dec. 2007)
GDP per capita	USD 1280 (WB, 2006)

Indonesia is an archipelago of 18,108 islands, 6000 of which are inhabited, stretching along the equator in South East Asia from Sabang in Aceh to Merauke in Papua. It is home to the fourth largest population in the world that, due the island structure of the country, represents a unique ethnic, religious, cultural and lingual diversity. *Java Man* (homo erectus) indicates that the archipelago was already inhabited at least 500,000 years ago. Although Indonesia became a nation state only in the early 20th century under the Pax Neerlandica, it has a history that dates back much longer in the form of major kingdoms: starting with Srivijaya in South Sumatra in the 7th century, via mighty Mojopahit in East Java in the 13th to Mataram in Central Java at the time of the beginning of colonialism and surviving to this present day in the four now largely ceremonial courts of Yogyakarta and Surakarta.

Migration from and trading contacts with mainland South and South East Asia have brought three of the world's main religions to Indonesia in consecutive waves: first Buddhism, then Hinduism and since the 13th century Islam, which became the predominant religion by the end of the 16th century. Colonial exploits by the Portuguese and Dutch brought the other two main religions in the form of Catholicism and Protestantism to Indonesia which mainly got rooted in the Eastern part of the country.

Colonialism for long was largely trade-driven but gradually transformed into a settler economy and actual occupation of most of the country by coercion or force when the

focus changed to agricultural production (sugar, tea, coffee, rubber) and the search for natural resources (oil, tin and other minerals). The Second World War and Japanese occupation ended colonial rule.

The Republik Indonesia proclaimed its independence on August 17th 1945 and has since gone through a volatile history. It started as a liberal democracy after the successful completion of its liberation struggle, widely known as the National Revolution, in late 1949. The liberal period was characterized by high levels of instability in the form of various regional uprisings and the inability of all governments to complete their term in office; in fact no single government ruled longer than two years. In 1957 President Sukarno imposed martial law and introduced the concept of guided democracy which translated into the forced political accommodation-at-the-top of the three major sectors in society (nationalists, religious groups and communists) under strong personal leadership by the president. It was accompanied by a system of guided economy which led to a substantial public sector (including the armed forces) involvement in the economy, particularly after the nationalization of Dutch corporations related to the ongoing struggle over the possession of West Irian (now Papua). With the help of the United Nations Indonesia successfully managed to include the territory into the republic but economic stagnation and decline caused increasing social and political unrest.

A failed coup by army officers in 1965 forced the army to step in and take control. President Sukarno was sidelined and later replaced by the army's strongman: President Suharto. Communism and liberalism were declared un-Indonesian and the Communist Party of Indonesia, the third largest in the world after its peers in China and the Soviet Union, was outlawed together with all the labor, farmer and other mass organizations under its aegis. Upon the new government's identification of the party as the mastermind behind the coup, hundreds of thousands of its members and followers were hunted down, imprisoned, exiled or killed. Shortly thereafter all remaining parties were forced to merge into two strongly state-monitored new entities whereas the government established a new almighty corporative party under the name Golkar that came to dominate the political scene until the ousting of President Suharto in 1998, and still is one of the stronger parties in the country.

Under his so-called new New Order leadership Indonesia became a politically stable country which facilitated impressive economic growth in the eighties and early nineties. It came, however, at a hefty price in the form of a nearly complete de-politicization of society, severe restrictions of human and civil rights, and overnight emergence of business tycoons who paid allegiance to the president and his family rather than the country or its population. Collusion, nepotism, favoritism and unprecedented corruption were the elements that increasingly kept the economy as well as the country together. The bubble busted in the aftermath of the Asian monetary crisis of 1997 which hit Indonesia profoundly harder than its neighboring countries. The Indonesian tiger proved to be a paper one only.

In the decade since President Suharto stepped down, the country has gradually normalized. It has returned to a multi-party system and free parliamentary elections and for the very first time in its history a president was directly voted in office by the people in 2004 in the person of Susilo Bambang Yudhoyono, popularly known as SBY. At the same time the last decade was a troubled one: the secession of East Timor, the Bali and Jakarta bomb blasts, the tsunami disaster in Aceh and Northern Sumatra, and earthquakes, volcanic eruptions and land and mud slides in Java.

Impact of Monetary Crisis as Reflected in Key Data	Pre-crisis	Crisis	Post-crisis		
	1993-1996	1998	2001-2006	2005	2006
GDP growth rate (%)	7.7	-13.1	4.8	5.6	5.5
o/w investment (%)	12.2	-33.0	6.7	10.8	2.9
Investment (% of GDP)	28.0	25.4	21.4	23.6	24.0
Exchange rate (average per US\$)	2,210	10,013	9,322	9,705	9,141
Exports (billions of USD)	43.0	48.8	72.1	85.7	100.7
Imports (billions of USD)	36.0	27.3	43.3	57.7	61.0
Trade balance (billions of USD)	7.0	21.5	28.7	28.0	39.6
International reserves (US\$ billion, eop)	13.8	22.9	34.3	34.7	42.6
Inflation rate (CPI, eop)	8.7	58.5	9.6	17.1	6.6
Budget balance (% of GDP)	1.2	-2.0	-1.3	-0.5	-1.0
Government debt (% of GDP)	24.3	74.1	57.8	46.8	39.1
Unemployment rate (%)	-	-	9.7	10.3	10.3
Poverty rate (%)	17.6	23.4	17.2	16.0	17.8

Source: World Bank (www.worldbank.org)

1.2 Macro-economic Situation and Indicators

According to the World Bank the Indonesian economy has picked up momentum in 2007. Economic growth has increased to 6.3% from 5.0% in 2006 and is mainly driven by investments and net exports (notably mining and mineral commodities) leading to a USD 10.8 billion current account surplus (equal to 2.5% of GDP) compared to a zero balance in 2005. Net international reserves have grown from USD 42.6 billion in December 2006 to 53 billion in September 2007. Inflation was brought down from 18.4% in 2005 to 5.3% in late 2006 but has since crept up to 6.9% by October 2007 mainly due to the price increase of foodstuffs. Commercial bank credit is reflecting the stronger economy: consumer lending, investment credit and working capital are all increasing in the range of 19-25% per annum.

Stronger economic growth is also reflected in employment records. Unemployment declined from 10.4% in early 2006 to 9.8% a year later. Whereas in that period the labor force increased by 1.8 million, 2.4 million new jobs were created primarily in the formal sector. Underemployment dropped sharply for young persons (from 30.4 to 25.4%) and for women (from 13.7 to 11.8%) with just a marginal decline for men. Males tended to move from the informal to the formal sector whereas females moved from unemployed to the informal sector. Going by regions the decrease of unemployment was sharp in Sumatra and NTT/Maluku² with Papua topping the list with an exceptional 60% decrease in unemployment, probably resulting from sharply increased provincial government spending.

The World Bank reports a firm increase in available resources at public sector level and allocation to development needs. Inefficient expenditures (particularly fuel subsidies) have been reallocated towards pro-poor programs. This translates into significant increases in budgets for public infrastructure and social sectors and these are much needed as Indonesia had fallen behind most other countries in the region with some of the lowest rates of access to clean water, energy and sanitation. Delivery of public services is increasingly left to regional governments since the start of decentralization in 2001. Regional governments today are responsible for nearly 40% of total government spending.

² NTT (Nusa Tenggara Timur) is East Nusa Tenggara Province: the Eastern string of the Lesser Sunda Islands including Sumba, West Timor and Flores.

In 2007 poverty has declined, reversing the deterioration experienced in 2006, due to strong economic growth, falling inflation and targeted cash transfers: 19 million poor households received IDR 300,000 (EUR 25.50) per quarter to compensate for fuel price increases. Still, a large part (17%) of the population remains vulnerable to poverty. Moreover, poverty statistics in Indonesia are volatile because of the large number of households clustering around the poverty line. If for instance the poverty line would be increased by 20% from the government applied USD 1.50 income-per-day proxy, the poverty rate would increase to 29%. In other words: small price changes in critical goods (rice, fuel) have disproportional effects on the country's poverty rate.

The incidence of poverty is highest in the Eastern regions of Papua, Maluku and NTT at 41, 26 and 23% respectively against 16.5% in Java and Sumatra. Across the board, the poverty rate in rural areas is 20% compared to 13% in urban areas. At the same time Indonesia appears to be on the right track as regards most of the eight Millennium Development Goals (MDGs). The number of people living on less than a dollar-a-day has already over-performed the MDG target of 10.3% by 2015 at a current rate of 8.5%. Net enrolment in primary schools remains high, including a good gender balance; under-five child mortality is falling steadily and access to improved water facilities has increased dramatically. Relatively under-performing are the decrease of maternal mortality rates and reductions in malnutrition

The Government is scaling up spending on poverty alleviation through a National Community Empowerment Program which currently covers well over 50% of all the country's sub-districts and aims for full coverage by 2009. This program focuses on improving local governance and service delivery at sub-district and village levels by encouraging participatory planning and providing block grants typically used for rural roads, education and health related projects. After realization of these block grant investments the program also offers so-called conditional cash transfers (averaging EUR 100 per year) to poor households to increase utilization rates of the newly completed services.

The economic outlook for 2008 is mildly optimistic. Economic growth is expected to slightly increase to 6.4%. In response to higher government spending, the lagged effect of falling interest rates and continued reforms, investment growth is expected to rise. This will offset an anticipated slowdown in exports due to slowing world demand growth resulting from the impacts of higher oil prices, the sub-prime debt crisis and a US economy slowdown. Continued demand from Asian countries for Indonesia's exports is estimated to partly compensate a downturn among industrial countries. Imports are expected to accelerate due to rising economic growth led by import-intensive investment spending. Inflation is expected to come further down to 6% from 6.5% in 2007.³

1.3 Social Issues

Despite improved economic performance and mildly optimistic outlook, the country faces serious challenges in terms of distribution of wealth as income disparities remain very high. Moreover formal employment records tend to conceal a substantial level of under-employment. Indicative is the extensive size of the informal and semi-formal sector:

³ World Bank, *Indonesia: Economic and Social Update, November 2007*, by Lloyd Kenward.

millions of Indonesians rely on self-employment not by choice but rather by lack of employment opportunities in the formal sector.

As regards HIV/Aids formal statistics tend to be outdated. The latest (from UNAIDS) are from 2004 and mention a number of 170,000 HIV cases, all concerning adults and 29,000 involving females whilst reporting 5000 mortal Aids cases. Most infections are contracted from sexual transmission and drug injections. Indonesia reportedly counts a quarter of a million sex workers with a clientele of 7 to 10 million with condom use estimated to be less than 10%. Risk behavior among injecting drug users is thought to have become by far the most common form of contracting HIV with prevalence as high as 48% among (former) drug users in rehabilitation centers.

Indonesia's national HIV/Aids strategy, formulated in 2003 by the National Aids Commission, outlines six priority areas, each with their own respective goals and objectives: surveillance, prevention, treatment, care and support of People Living with HIV/Aids and government coordination at all levels. The strategy also provides donors a clear framework within which to work and provide assistance.

HIV/Aids as yet has not prominently appeared on the radar screen of microfinance institutions (MFIs). One widely quoted reason is that the participation of NGOs in microfinance is fairly small. Another is that the private and public sector at large have not yet moved into work floor policies. This may change with the expected further spread of the disease. Outside the realm of microfinance attention is sharply on the rise, however, with at least 60 websites providing HIV counseling services and 25 hospitals providing HIV testing as well as treatment of sexually transmitted infections. As of mid 2004 the Government started providing access to subsidized antiretroviral therapy to everyone needing treatment. In the same year the country introduced drug substitution therapies in two state-owned hospitals.

Malaria, dengue and water-borne diseases are common and the country ranks third in contributing the highest number of tuberculosis cases to the world's burden, with an estimated 582,000 new cases each year.⁴

Indonesia has ratified the major international conventions that uphold principles of gender equality and the empowerment of women. The Government's Medium Term Development Plan 2004-2009 identifies gender mainstreaming as a target under the theme of establishing an Indonesia that is just and democratic. Whilst this has led to the production of gender-disaggregated statistics, the application of a Gender Analysis Pathway in a range of ministries and an increasing number of gender issues included in development plans at district level, much remains to be done. There is often a lack of understanding of the benefits of mainstreaming gender and poor staffing and under-facilitation of women's empowerment divisions in public sector institutions.

The decentralization process has provided a mixed bag of challenges and opportunities for Indonesian women. In some areas it has been accompanied by a revival of conservative religious interpretations of gender roles and discriminatory local customary roles. At the same time local governments have begun to view women as important stakeholders and introduced more gender-responsive budgets.

⁴ www.youandaids.org

Women's political participation was very low in Indonesia under the New Order. Since, participation levels have modestly increased. Yet, today only 11% of members of parliament and only 4 out of the 36 cabinet members are female today, although they occupy more senior cabinet posts than in the past. Still, if measured in terms of Gender Empowerment Measure (GEM), a statistical instrument to calculate female participation in public positions, Indonesia's rating is superior to those of neighboring countries such as Japan, Korea, Malaysia, the Philippines and Thailand.

Violence against women is a major challenge in Indonesia and is categorized in domestic violence, violence in conflict and post-conflict situations and trafficking; the latter related to irregular migration and mainly affecting women and children who are trafficked for sexual or labor exploitation. Documentation is poor but it is believed that up to four million women and children are vulnerable to trafficking whereas domestic violence is often considered a private rather than a public issue resulting in relatively few cases being exposed. Nonetheless, Indonesia established a National Commission on Violence Against Women in 1998 and enacted the Law on the Elimination of Domestic Violence in 2004.

Violence against and ill-treatment of Indonesian overseas workers has become a sensitive national concern and currently a source of recurring tension with neighboring Malaysia that does attract many Indonesian domestic workers alongside most Arab Gulf states.⁵

In the 2006 Human Development Index (HDI), based on 2003 data, Indonesia ranked 110 out of 177 countries. On the Gender Development Index (GDI) it ranked 87 out of 177. This indicates that on gender issues Indonesia may perform better than other countries, but does not indicate that women are better off than men. Statistically they only outscore men if it comes to life expectancy; they trail in literacy rates (83.4 versus 92.5%), school enrolment (65 against 67%) and estimated earned income (USD 2,289 versus 4,434 measured in purchasing power parity).⁶

⁵ It is estimated that up to 1.5 million Indonesian women work overseas as domestic workers. In addition Malaysia, unlike the Gulf States, employs larger numbers of low-skilled male workers. Many of those work illegally and a reason for tension is that these illegal workers are regularly rounded up and deported, especially if elections are coming up. Tension with Malaysia is also building up over the issue of 'appropriation of Indonesian cultural heritage' in the process of building a Malaysian (or rather Malayan) cultural track record.

⁶ Asia Development Bank (ADB), *County Gender Assessment Indonesia*, July 2006.

2. THE FINANCIAL SECTOR

2.1 General Overview

The Financial Sector

The banking sector has shown considerable improvement in overall performance and is now rated as 'sound'. State-owned banks still under-perform the overall banking sector due to higher levels of non-performing loans and high transaction costs. At the same time the share of state banks in the overall banking sector has come down from 46% in 2002 to 36% in 2007 and the government is continuing its gradual privatization policy. Most state banks have been partially privatized and discussions have started to also privatize or merge the last fully state-owned bank: BTN, the National Savings Bank.

A first main instrument for consolidation of the banking sector is the steady increase of capital requirements. Minimum Tier 1 capital levels for existing commercial banks have been raised to IDR 80 billion (EUR 5.7M) as per December 2007 and will be further increased in the coming years to IDR 100 billion (EUR 7.1M). A second instrument is the so-called Single Presence Policy as per October 2006 intending to prevent a person or company from owning shares in more than one bank. Both instruments have met with criticism. As to the first, minimum capital levels are still considered fairly small by international standards. Moreover the central bank's announcement to force some smaller banks into a process of merger and acquisition is often criticized as overly focusing on the reduction of the number of banks instead of an increase of the number of good banks. As to the second instrument, the implementation has been delayed and terms amended, partially to exclude the government.

The Indonesian financial sector is made up of a broad range of institutions but dominated by formal banks which constitute 75% of the sector, the remainder made up of finance, foreign exchange and venture capital companies, the (recently merged) Jakarta and Surabaya stock exchanges, pawn shops, cooperatives, credit unions, etc. The formal banking sector has two basic institutional formats in the form of commercial banks (covering both privately and state-owned banks) and rural banks; the latter category being nearly exclusively made up of urban and peri-urban based People's Credit Banks (Bank Perkreditan Rakyat or BPR). Both formats have a special slot for *syariah* banks that apply Islamic banking principles and are supervised by special divisions of the central bank (Bank Indonesia or BI). By August 2007 Indonesia counted 130 commercial banks and 1821 BPRs.

As in most formerly colonized countries, the formal banking sector emerged out of a colonial banking infrastructure the heritage of which still lives on in the state-owned banks. One of these, Bank Rakyat Indonesia (Indonesian People's Bank or BRI) traces its roots back to 1895 as a credit and savings bank for Indonesian civil servants and is now widely regarded as a microfinance icon in the form of its famous BRI Unit division.

The Microfinance Sector

The country has a wide variety of Microfinance Institutions (MFIs). Not only all types of formal banks are involved one way or the other, but also a bewildering number of other institutions and programs. A public joke has it that except for the National Archive all government ministries and institutions have their own microfinance distribution system. This dates back to concerted and long-standing efforts of the Government to play an active role in poverty eradication through the provision of easy access to capital to small

farmers, which traditionally made up the vast majority of the poor in the country. In later years the same approach was targeted to the rapidly growing numbers of informal sector workers as that sector increasingly provided the only employment vehicle for the rapidly growing labor force in the country.

Today formal microfinance, understood in terms of financial service provision by central bank regulated and supervised institutions primarily focuses on what the central bank in English calls SME lending but in Bahasa Indonesia MSME lending.⁷ At the same time targeted credit provision by Government institutions still have some focus on small agricultural production, mainly provided through formal village-based institutions and departmental programs.

Next to a major *private* and *public* sector involvement in microfinance, the country also counts a quite substantial *mutual* sector in the form of thousands of cooperatives, credit unions and informal savings and credit groups. Cooperatives and credit unions are formally supervised by the Ministry of Cooperatives but supervision is reported to be weak and inefficient. Unlike other major microfinance markets, Indonesia has relatively little in the way of a *civic* sector in the industry. There are various NGOs involved in microfinance but overall their programs are relatively small and rarely in line with international best practice conventions.

Another typically Indonesian feature of microfinance is that it is a home-grown industry, attracting very low levels of foreign capital input and not facilitating market entry of foreign operators at retail level. Three basic obstacles account for this feature. First, the foundations act does not easily allow for non-profit institutional formats except in mutual settings. Second, BPRs are prevented from foreign ownership or foreign capital infusion. Third, the domestic capital market is highly liquid due to very high savings and deposits rates in combination with limited capital absorption capacity of the real economic sector which means that Indonesian microfinance operators across the board in principle have little need for sourcing their capital overseas.

A 2002 draft bill designed to come to a new regulatory microfinance architecture got stuck and it is not expected that major changes will be pursued in the years to come. This means that foreign donor agencies, investors and operators will continue to have only limited options available to contribute to Indonesian microfinance in terms of capital provision. Options usually available in other major microfinance markets can not be easily considered in Indonesia. This paper will therefore particularly focus on the limited options that are available or could be further perused.

2.2 Demand for Microfinance

In Indonesia demand for micro-financial services is commonly defined in terms of MSMEs: a huge section of the labor force is depending on employment or self-employment through micro, small and medium businesses. Strengthening these small businesses is therefore seen as crucial for economic development and job creation.

Poverty-wise nearly one out of five Indonesians live in poverty, defined in terms of living on less than USD 1.50 a day. Of all people living in poverty about two-thirds live in rural

⁷ Respectively Small and Medium Enterprises and Micro, Small and Medium Enterprises (KMKM: Kredit Mikro, Kecil dan Menengah).

and one-third in urban settings. Though the incidence of poverty is highest in the Eastern outer islands (measured in percentage of the population), by far most of Indonesia's poor live in Java and Bali (measured in number of people) due to the large concentration of people there. In these two islands employment extension in agriculture is severely limited due to a shortage of land. In fact, average land holdings have contracted to a land acreage that more often than not can not fully sustain a land-owning farmer and his family any longer. As a result the poor have few options for (additional) employment left but in the MSME sector since the absorption capacity of both the real economy and the public sector is rather limited. MSMEs therefore constitute the bulk of the demand side in microfinance.

Next to that sector there is continued demand for agricultural (farm input) finance and over the last decade the demand for consumer finance has grown exponentially. In fact, the banking sector has quite professionally tapped into this new working area. A prospective buyer of a new television set or motor cycle is constantly reminded of the virtues of buying on credit. Loan officers of respected banks will actually come to his residence to offer and settle the loan. Purchase of consumer goods is often defined in terms of the costs of periodic payments rather than the actual retail price; a practice also broadly adopted in regular microfinance.

Yet, in Indonesia more people save than borrow but they borrow more than they save. BRI Unit, the county's flagship microfinance institution, has nearly ten times more saving than borrowing clients. If it comes to savings, the institution is by far the largest MFI in the world, but as regards borrowing clients Bangladeshi super-sized MFIs Grameen Bank, BRAC and ASA are each about twice as large.

The high savings and deposits ratio in Indonesia is a major reason why the country's microfinance industry has developed little need for foreign capital infusion: there is a high level of liquidity in the market and also in parts of the microfinance sector.

2.3 The Finance Gap

Despite the unparalleled high number of MFIs and the availability of capital ready for microfinance there exists a considerable gap between supply and demand in microfinance. The reason for that is to be found in the urban focus of most MFIs. Indicative is that BRI Unit Desa dropped the word *desa* (village) from its name. Likewise, whereas BPRs are classified as rural banks by Bank Indonesia, they rarely operate in rural settings.

BPRs are for-profit shareholding companies and even though some founders or owners may have started off with a mixture of social and business consideration, developments in the market have led to the predominance of the latter. Competition has driven down interest rates over loans, squeezing operational margins. At the same time interest rates over savings have gone up. BPRs, as all banks, have to pay good interests, often linked to lottery or other bonus systems, to capture savings to finance their lending operations related to low equity levels, the prohibition to attract offshore loans from funding agencies or specialized microfinance funds and cumbersome procedures and inappropriate terms related to borrowing in the domestic capital market. At the same time competition led to a downwards trend in interests received over loans. So to keep margins profitable and stay ahead of competition BPRs have come to focus on lower-cost service delivery in urban settings. BRI Unit has joined the same trend since its mother company

(BRI proper) has been partially privatized and since its Unit division has become regarded as a main revenue stream for the bank at large, particularly in the wake of the monetary crisis that hit the bank pretty hard but left the Unit relatively untouched.

The basic gap in demand and supply in regulated microfinance is therefore two-fold. On the one hand, in Java and Bali (and major parts of Sumatra and Kalimantan) there is no lack of MFIs but rather a lack of rural service provision, and on the other in Eastern Indonesia there is a more overall lack of service provision.

The rural poor and part of the urban poor to a certain degree are serviced by all kinds of pro-poor targeted Government support that can take the form of direct grants, soft loans, non-recoverable loans and real loans. Though the volume of targeted support is high, it only marginally contributes to building sustainable financial distribution systems.

There are few niche players that make serious work of providing microfinance services to the rural poor. Some NGOs have built a track record in this area but often their operations fail to become financially sustainable and their volume expands and contracts with the availability of donor assistance. Some BPRs have managed to escape competition in urban settings by moving further away from the crowd but in general this has led to a renewed focus on peri-urban settings at best. Very few are operational in real rural areas as yet.

There is growing interest of specialized offshore rural service providers, mostly from Bangladesh, to become active in rural retail finance in Indonesia, but they face a major double obstacle in the absence of a regulatory operational slot for both non-profit and foreign MFIs. Now that the introduction of a new regulatory architecture has been put on hold they appear to have one option left only in the form of establishing or buying an existing fully licensed commercial bank in Indonesia. It is not clear if this option is actively pursued to date.

As it is, the rural poor largely depend on their own member-based institutions to get access to financial services, beyond participation in public sector programs. Actually there does not seem to be a lack of such operators in the form of cooperatives and credit unions, including reportedly good ones, but across the board performance and supervision are challenged as will be explained in a next section.

2.4 The Emergence of MFIs

Early pioneers were the *Poerwokertosche Hulp- Spaar- en Landbouwcredietbank* founded in 1896 and the *Postspaarbank* founded in 1897. Today their legacy lives on in state-owned banks BRI and BTN⁸ respectively. BRI is by far the largest microcredit provider through its Unit program and BTN has come to concentrate more on the lower end of the housing market.⁹ Also originating from the colonial era are the many BKDs (Badan Kredit Desa, Village Credit Institution) operating under central bank supervision.¹⁰

⁸ Bank Tabungan Negara or National Savings Bank.

⁹ Interestingly in the early nineties BTN worked with Oxfam Novib-supported Stichting Garantiefonds Habitat Indonesia (SGHI) in Almere to develop a *triguna* (three-in-one) credit product for social housing cooperatives that included land purchase, site development and house construction costs and mortgages to end-users in one package deal partially covered with a guarantee by SGHI.

¹⁰ BKDs were founded as per Staatsblad no 357, 1929, and Rijksblad no 9, 1937, and no 3/H,1938.

In addition to these two state banks and about 4000 BKDs, in the early years of the Republic the Government also encouraged the formation of microfinance institutions to serve the grass roots. A major one was Bank Pasar which served traders in the marketplace; later followed Bank Desa, Lumbung Desa, Bank Pegawai, Bank Koperasi and many others.¹¹ Since, the country has witnessed the development of a patchwork of all kinds of formal and semi-formal public sector MFIs (see Annex 2 for more details), generically known as LDKP (Lembaga Dana dan Kredit Pedesaan, Village Finance and Credit Institutions). The latest addition to that string came in the form of regional development banks, some of which have only recently emerged with the public sector's decentralization policies.

In 1967 the New Order Government passed a new banking law (Banking Act No. 14/1967) which explicitly focused on the priority of loan extension to farmers, fishermen and craftsmen, to be channeled through cooperative institutions. This law clearly formulated the concept of a *public good* in microfinance:

“... considering that such communities are economically weak but represent the basis of our economy which needs to be strengthened, the Government must establish certain policies directing it to contribute to the costs thereof, if need be, as a consequence.”

The act forced all credit institutions (the vast majority of which were public sector facilities) to regularly report to the central bank whilst the precise modalities of supervision would be stipulated by separate regulation.

The BPR format was introduced in 1988 to promote the formation of small scale yet regulated privately owned micro banks all over the country. In the subsequent regulations, the government required any deposit taking institutions to adopt the form of either BPR or commercial bank. Except for LPD in Bali that obtained special permission from BI to operate without being converted into a bank, most lower-level local government banks were actually required to transform.¹² Many could not meet the required thresholds and simply continued operating as usual, thus creating a main grey regulatory area. Others transformed into cooperatives to escape the new regulation which allowed further savings intake but from members only.

Following cycles of regulation and deregulation since 1971, the Indonesian banking sector is currently in the tightening phase. The central bank requires banks to considerably increase their equity capital; for BPRs from IDR 50 to 500 million (EUR 36,000 and 360,000) and for commercial banks from IDR 10 to 100 billion (EUR 715,000 and 7,150,000) by 2010. To encourage the opening of BPRs outside Java and Bali, paid-up capital requirement for established BPRs in Jakarta and the provincial capitals of Java and Bali is higher. To establish a new commercial bank requires paid-up capital levels of IDR 3 trillion (EUR 214 million). In addition non-financial requirements have been sharpened such as the mandatory implementation of Basel II risk management standards for commercial banks, certification of bank officials for commercial as well as rural banks

¹¹ Respectively: Market Bank, Village Bank, Village Rice Storages, Civil Servants Bank and Cooperative Bank.

¹² Indonesia has a six tier administrative system differentiating between national, provincial, district (kabupaten), sub-district (kecamatan), village or town (kelurahan) and neighbourhood (rukun warga or RW) levels.

and more detailed reporting formats. As a result from this new banking architecture¹³ the number of private commercial banks in Indonesia has come down from 141 by late 2002 to 130 in August 2007 with cumulative branch offices steadily increasing from 7001 to 9571 in the same period. Likewise the number of BPRs dropped from 2141 to 1821 with offices increasing from 2747 to 3222; in both cases indicating a successful start of the anticipated process of merger and acquisition.

At the same time commercial banks and BPRs with an asset base of IDR 10 billion (EUR 715,000) now have to feed information on their borrowing clients into the national credit bureau (Sistem Informasi Debitur or SIB) which reportedly functions well. This widens the gap between MFIs regulated by the central bank in conjuncture with the Ministry of Finance and those supervised by the Ministry of Cooperatives as well as non-supervised practitioners.

2.5 Current MFIs

Indonesia is blessed with a large variety of MFIs of all institutional formats. A common categorization follows supervision models. Under BI regulation come the commercial banks and BPRs: these are predominantly for-profit commercial entities that by and large profitably service the MSME market with loan products and take savings and deposits from the public at large. Whereas BPRs are the entities that were particularly established for micro-financial services, also most commercial banks have entered this field, especially after the monetary crisis that contracted investment opportunities in the real economy. Also supervised by the central bank are other institutions such as the largest cooperative bank (Bukopin), province-owned regional development banks (BPDs, Bank Pembangunan Daerah), and village banks of the BKD variety (Badan Kredit Desa, Village Credit Institution). Supervision of these village banks is actually outsourced to BRI and BPDs.¹⁴

BRI Unit is by far the single biggest player in this category. By late 2006 BRI was servicing 3.4 million borrowers with an outstanding portfolio of IDR 27 trillion (EUR 1.9 billion) and 36 million savers who brought in IDR 44 trillion (EUR 3.1 billion). Bank Danamon is a commercial bank that is rapidly progressing in microfinance through its Danamon Simpan Pinjam (DSP) division which by late 2006 served 133,000 borrowers with a portfolio of IDR 10 trillion (EUR 713 million) and 220,000 savers and depositors. These are the only two banks that disclose their microfinance operations. Bank Mandiri is reportedly heavily involved in microfinance through its Unit Mikro Mandiri (UMM) division but no figures are available.

Below is an overview of the size of the commercial banking sector based on the central bank's latest published data.

¹³ The phrase *architecture* was introduced by the current BI governor who is an architect by background and replaced the previously common phrase banking *landscape* introduced by his predecessor who was an agricultural engineer.

¹⁴ BRI supervises BKDs founded in colonial times; BPDs other village credit institutions.

Commercial Banks	Number	Offices	Loan Capital Outstanding IDR billion	Savings and Deposits IDR billion
Private banks	130	9459	913,950	1,400,800
Private national banks	71	4319	393,570	587,720
State-owned banks	5	2006	321,204	499,326
Foreign-owned banks	11		77,445	108,598
Regional banks	26	822	70,900	153,631
Joint venture banks	17		50,830	51,525
Syariah Banks	28	549	31,259	27,085

Bank Indonesia statistics as of September 2007

Their outstanding loans were classified as follows:

Commercial Banks	Small/Micro < 500M	Medium 500M-5B	Large > 5B	Total IDR billion
Working capital	74,849	111,125	275,708	461,682
Investments	18,397	25,290	130,756	174,443
Consumption	16,130	215,905	25,337	257,372
Total	109,376	352,320	431,801	893,497

Bank Indonesia statistics as of August 2007

In other words, almost one-eights of the current portfolio of the commercial banking sector in Indonesia is characterized by Bank Indonesia as small or micro loans, without any further details provided on the differentiation between both.¹⁵ More indicative to assess the size of the microfinance sector is to look at the number of borrowing clients.

However, there is no central data base available to consult for that purpose. Figures presented below have been compiled from various resources and are most likely not altogether accurate; if only because they mostly cover performance in 2005 and 2006 depending on availability of data. Moreover, it was necessary to correct some figures for double counting. BRI Unit does not only run a microfinance program on the basis of its own capital resources, but also on an off-balance-sheet funds-under-management format using the capital base of third parties. Its figures below only represent the first type of its microfinance activities.

Whilst probably not altogether accurate, the table below presents a reasonably approximation of the overall size of the market, except for public sector targeted microfinance. Credit and saving figures are in IDR millions. Total outstanding loans of IDR 94.5 trillion equal EUR 6.7 billion; savings of IDR 61.1 trillion equal EUR 4.4 billion. The listing below is biased to number of borrowing clients. Loan capital and savings amounts are in IDR millions.

BI-Supervised Banks	Borrowers	Loan Capital	Savers	Savings
BKDs (Village Banks)	13,793,710	5,141,067	440,457	39,298
BRI Unit	3,440,000	27,282,616	30,907,566	43,768,152
BPRs	2,470,681	16,948,462	6,189,920	4,581,112
BPDs (Regional Dev. Banks)	1,037,989	21,874,292	1,990,783	8,804,556
Bank Danamon	180,500	6,228,000	334,100	339,000
Bukopin	55,990	381,141	175,979	211,402
SUBTOTAL BANKS	20,978,870	77,855,578	40,038,805	57,743,521

¹⁵ Micro loans are defined as below IDR 50M; small loans between 50 and 500M.

Non-Banking MFIs	Borrowers	Loan Capital	Savers	Savings
USP (S&C Units of Coops)	10,524,908	13,495,662	4,987,783	1,454,578
KSP (S&C Coops) ¹⁶	878,379	1,154,816	480,326	325,271
LPD Bali ¹⁷	363,045	1,753,630	1,092,605	1,048,594
BMT (Shariah Coops)	280,000	1,200,000	450,000	1,500,000
LSMs (NGOs) ¹⁸	205,404	311,440	177,494	112,432
Pawnshops	55,288	483,237	-	-
SUBTOTAL NON-BANKS	12,307,024	18,398,785	7,188,208	4,440,875
Grand Total	33,258,894	96,254,363	47,227,013	62,184,395

2.6 Targeted and Informal Microfinance

Parallel to the commercial and mutual MFIs, there operate many subsidized loans providers. Most state-owned companies, known as BUMNs¹⁹, have corporate social responsibility programs with a microfinance component, all with subsidized interest rates. Other government programs provide credits to poor households or micro-entrepreneurs, some at subsidized interest rates, some with a rotating fund structure with usually low repayment rates.

Subsidized credit provision by all kinds of governmental departments and institutions became very popular in the seventies and was inspired by the wish to reach the many Indonesians not serviced by the formal banking system. Since, nearly all poverty alleviation programs sponsored by the Government almost routinely came to adopt some form of low-cost credit provision; sometimes directly administered by existing Government institutions, sometimes also implemented by specially created new institutions and at other times outsourced through third parties such as NGOs, banks or cooperatives. The limited experience of the program officers in credit extension and loan collection, coupled with a growing understanding among the general public that credit from government program needed no repayment, made most perform poorly. Many have disappeared into oblivion in the course of time.

As these programs were reported to potentially undercut a healthy credit culture and provided unfair competition in the market, the Government eventually decided to tackle the problem at least partially by establishing a coordinating body in the form of LPDB (Lembaga Pengelola Dana Bergulir, Supervisory Institution for Rotating Funds) to be launched in 2008. All the same, a major new program was launched in 2007 in the form of PNPM Mandiri and the Coordinating Minister for People's Welfare went on record in December 2007 by stating that 30% of the ministry's budget would be utilized for microfinance activities.

¹⁶ KSP stands for Koperasi Simpan Pinjam (Savings and Credit Cooperative); USP for Unit Simpan Pinjam (Savings and Credit Unit), usually the MFI department of a general or multi-purpose coop.

¹⁷ LPD Bali figures are as per end-of-year 2007, originate directly from the bank after Gema PKB figures proved to be wrong and are exclusive of LPD's 75,000 depositors.

¹⁸ LSM: Lembaga Swadaya Masyarakat (Community Self-Reliance Institution), the generic phrase for NGOs in Indonesia as the *non-governmental* notion in the New Order era was routinely appreciated in terms of being *anti-governmental* for which there was little tolerance. Yayasan Bina Swadaya is the largest NGO active at microfinance retail level.

¹⁹ Badan Usaha Milik Negara: State-owned Corporations such as public utilities in water, power, communication and transportation.

Whilst conventional thinking in the microfinance industry tends to speak out against all kinds of public sector targeted credit, it would be a simplification to accuse the Government of willfully going against best practice thinking in the industry as there are strong pushing factors at play as well. It is not uncommon to see targeted credit appear and reappear in all kind of major development programs supported by multilateral players such as the World Bank, Asia Development Bank (ADB) and the International Fund for Agricultural Development (IFAD). To their credit, at least the management of such credit component today is usually outsourced in the form of funds-under-management to reputable institutions such as BRI and BNI, such as in the case of the P4K²⁰ and the Prosperous Family Program²¹ respectively.

Operating at a smaller scale but more at grass root level, there are self-help groups with saving and lending activities run within the existing community groups such as women's groups and neighborhood-based informal savings and credit schemes or *arisan*. Rural development NGOs also have a tradition of including smaller credit components in their integrated programs. In areas where none of the above facilities exist, people will find credit from family and friends and individual money lenders whose average interest rates have come down to 20-50% per month. In Indonesia no license is needed for loan provision as long as one works on one's own account. Licensing only is a necessity if funds for on-lending capital are solicited from the general public. Savings collection from group members is unregulated if done below the level of cooperatives and credit unions.

2.7 Products and Pricing

Most loans under IDR 50 million (EUR 3571) follow a rather similar design: daily (working day) repayments and a flat interest rate of 2 to 5% per month with tenures of 2 to 3 months. Interest rates will be lower and tenures longer as the loan amount increases. Interest rates tend to be pushed down towards the 2% per month mark in cases of stiff competition in the market.²² Operators in microfinance usually do not apply group-lending methodologies as clients prefer individual lending and generally can put up collateral, usually in the form of easily sellable assets such as motorcycle property deeds.²³ Repayment rates are usually high and operators do not think they are exposed to

²⁰ Pembinaan Peningkatan Pandapatan Petani-Nelayan Kecil (PPPPK or simply P4K, Support to Increase Income for Small Farmers and Fisherfolk) which operated under the Ministry of Agriculture in 12 provinces and almost 10,000 villages reaching 66,000 groups (phased out in 2005).

²¹ A major program implemented under the National Family Planning Coordination Board (BKKBN: Badan Koordinasi Keluarga Berencana Nasional) that promoted credit, training and savings through 67,000 self-help groups.

²² To international standards interest rates are high if calculated in effective rates per year. A flat rate of 3% per month translates into an effective rate of around 50% per year. At the same time the small tenure of Indonesian loans keeps them within the pricing limit advocated by the Alliance of Fair Microfinance which stipulates that a loan should not cost more than a third of the loan amount: 3% flat interest per month translates into 5% of loan volume per month, which equals a cost level of 10% for a two months loan and 15% for a three months loan. In fact, some players in Indonesia provide day loans at 10% per day; whereas this hypothetically works out at 3600% flat or well over 5000% effective per year, the client in real monetary terms just pays 10% for the loan nonetheless, which he or she is gladly willing to pay against a daily business profit on the loan of around 30-35%.

²³ Buying a motorcycle for productive purposes represents main business in microfinance in its own right. It is the common means of transportation for small traders and also a popular mode of public transportation in congested cities, usually called *ojek*. It remains unclear if the statement that most clients can put up collateral (in ProFi reports) refers to *current* microfinance clients only or to *all* low-income Indonesians.

significant non-repayment risk as they usually meet their clients daily in or near markets to collect the repayments; that way their clients do not easily run into arrears.

Above the IDR 50 million mark loans mostly take the form of more conventional banking loans with interest calculated over declining balance, longer tenures, weekly or monthly repayment schemes, etc. At the same time especially cooperatives have developed a habit of charging extra costs to clients. One popular way is to instantly deduct 10 or 15% from the loan amount and re-collect those as mandatory savings whilst the client pays interest over the full amount borrowed. Another is to keep transparency levels low by advertising repayment schemes instead of interest rates, let alone effective interest rates, and to not facilitate easy comparison between MFIs; just as consumer finance companies do.

Smaller loans are commonly insured against death and property loss for loans as of IDR 5 million (EUR 357). Often clients are given an option as especially older clients may consider the premium too expensive or do not think they really need life insurance.²⁴

²⁴ In most parts of Indonesia it is common that the community contributes to burial and related costs, often leaving a surplus for the relatives of the deceased. Moreover, these relatives often repay outstanding debt of the deceased to ensure his or her passage to heaven.

3. TRENDS AND ISSUES IN MICROFINANCE

3.1 Market Trends

Due to competition in the market average loan sizes tend to go up quickly. This can not easily be perceived in terms of mission drift as most operators right from the start have concentrated on the MSME market at large. Very few MFIs have a professed policy that requires them to concentrate on micro-loans. The Indonesian industry considers all MSME lending as microfinance leading to a large bandwidth in loan sizes.

And whereas commercial banks have entered the realm of microfinance, a growing number of BPRs is entering the playing field of commercial banks with loans well over IDR 100 million or EUR 7,142. At the other end of the scale other BPRs continue to extend loans as small as IDR 500,000 which is less than EUR 36 even if there is relatively little appetite in the market for loans smaller than IDR 1 to 2 million (EUR 71 to 143). The leading BPR in the Yogyakarta region, Danagung, has in fact returned to low-end loans to meet demand in the local Beringharjo market where traders showed preference for small loans in this range with daily repayments. Back at the other end of the scale the largest BPR in Indonesia, Eka Bumi Arta in Lampung, Sumatra, has entered into payroll lending for corporate employees.

Similar trends can be witnessed in the mutual market. Some coops, such as the Inti Dana Cooperative in Central Java, have moved up in the market providing loans as high as IDR 300 million or nearly EUR 21,500 whereas a major cooperative from Pekalongan, Central Java, Kostpin Jasa, is reported to provide loans as large as IDR 1.7 billion (EUR 121,000). Across the board, however, most mutuals move in the lower brackets of the market which is in the IDR one to five million range (EUR 71 to 375), predominantly serving market vendors with daily repayment-based loan products.

A reasonably well developed practice in Indonesian microfinance is the demand-based and strongly individualized design of loan products. Product development centers around what clients actually need to maintain or grow their business, rather than focusing on what the MFI has available or on elaborate graduation schemes. This is undoubtedly facilitated by the fact that the vast majority (90%) of Indonesian households have assets that would qualify as collateral. Accordingly lack of collateral is not widely regarded by banks as an obstacle to access microfinance services. The opposite position is popularly aired by governmental microfinance programs but perhaps more as a justification to design targeted programs than inspired by realities on the ground.

The main concern about the commercial MFIs is their location. With the exception of pawnshop, they tend to cluster in business centers (mostly traditional markets) in Java, Bali and Sumatra leaving other areas under-served. In its effort to make available financial services in more remote areas BI has already tried to shy BPRs away from the larger cities in Java and Bali, using both regulatory requirements and persuasion. BPRs, finance cooperatives and other MFIs have, however, built a tradition of smart maneuvering in this respect. They are keen in setting up offices just outside the formal boundaries of capital cities or urban districts whilst serving clients in these localities. There is little the central bank can do to prevent this happening.

Not really a recent trend, but gaining prominence nonetheless is Islamic banking. It came up in the later years of the New Order and has since grown steadily, first in the form of syariah banks and later also through syariah BPRs. Over the last years growth rates of

30% have been realized. The quintessential principle of Islamic banking is the prohibition of *riba*: lending is not allowed against a pre-set interest rate to prevent one party in the transaction (the borrower) assuming all the risk. The reward for the services of the lender has to be linked to the economic rather than the monetary performance of the loan. Islamic banking has developed a range of lending products that mostly work along the principles of profit sharing. Bank Indonesia has installed special regulatory slots for syariah banks and BPRs and there is growing overseas interest to strengthen this sector, mostly from the Gulf States and Malaysia but also from investors and supporters from Western countries that appreciate the ethical considerations underlying Islamic banking.²⁵

3.2 Regulation

As explained in earlier sections, a considerable part of Indonesian microfinance operates in a grey area as regards regulation and licensing. A useful way to break down the problems related to this situation is to distinguish between *institutional* and *program-based* microfinance. The first refers to service delivery by legal entities established and specialized in microfinance and the second to usually time-bound interventions by all kinds of public and civic sector institutions.

Institutional finance is only partially regulated and supervised. What comes under central bank supervision is pretty straightforward: commercial banks, BPRs, BPDs and BKDs are licensed and actively supervised by BI and its branch network throughout the country or through the BRI network. But that does not imply that there are no obstacles. The major ones are that BPRs can not be foreign-owned, not even partially, and can not obtain foreign capital. This effectively cuts off BPRs from obtaining debt finance and equity from international microfinance investment funds, donor agencies or development banks. Moreover, because BPRs have the status of for-profit shareholding companies, they are also largely cut off from donor grants as many donors have self-imposed rules to not provide funding to for-profits.

What comes under regulation from the Ministry of Cooperatives is mutual microfinance. Problems in this field are of a different nature. First, the effectiveness of supervision is an issue, partly because there are thousands of mutual operators with many still coming up as the cooperative format is seen as a legal soft landing format for MFIs that can not meet BPR thresholds, both for-profits and non-profits. The workload has reached such levels that it is virtually impossible to speak of effective regulation. Cooperatives have to send their reports quarterly to the Ministry and popular wisdom has it that the larger part thereof is immediately shelved; unread that is. Occasionally Ministry staff conducts site visits but these usually do not take long.²⁶

Restructuring operations along a cooperative legal format may save the day in terms of continued access to savings intake but also undercuts the essential concept of mutuals as

²⁵ The size of syariah banking is still relatively small: 3 out of the 160 banks and 108 out of the 1821 BPRs are syariah institutions. In addition time 24 commercial banks have a special syariah department. In terms of loan balances: syariah BPRs have a combined loan balance of 1,004 billion out of the overall BPR amount of 19,887 billion. In the commercial banking sector syariah banks and syariah units of other banks have a loan balance of 18,926 billion against the overall 707,779 billion outstanding.

²⁶ As a major cooperative player explained: “You just need some smart talk and give them some report to file” indicating that there was no urgent need for such reports to reflect actual financial performance on the ground. When suggesting that perhaps some small bribes were part of that process, he replied: “No way, that would just make them come back”.

member-based self-managed and self-governed organizations; a notion that was heavily eroded under the New Order system already by the emergence of super-sized 'state-controlled' coops with mandatory membership requirements. And that is what is happening across the sector. Quite a few formal cooperatives are little more than personalized profitable money-lending vehicles.

This does not necessarily mean that service provision is poor or exploitative but it does mean nevertheless that such operations are a far cry from being genuinely mutual or member-based. And that implies that external supporters such as donor agencies or capital providers should be carefully checking the institutional credibility of cooperatives before deciding to become involved as coops, unlike BPRs, are allowed to borrow overseas. The very word cooperative can not be considered at face value as a non-profit, member-based organization.²⁷

Institutional microfinance that is not regulated presents other challenges. NGOs operate in a double grey area. As unregulated entities they are not allowed to become directly engaged in savings activities, usually their entry point for working at grass roots level. And as foundations they are not allowed to be predominantly active in economic activities in the first place; defined in terms of 25% of their assets. These obstacles tend to immobilize *civic* microfinance, which in many countries provides the natural habitat for foreign funding agencies to become involved with capital and grants. Since the turn of the century various parties have promoted the formal acknowledgement of this civic microfinance sector by lobbying for a so-called Non-Bank Non-Coop (NBNC) legal format. Whereas the lobby for some years appeared to be successful, as witnessed by the 2002 draft law on microfinance, in the end it failed. The draft got stuck and it is unlikely to expect any change to the current regulatory architecture in the coming years; there does not seem to be sufficient political support for such changes at this point in time.

But then again, legal obstacles do not necessarily lead to straightforward prohibitions. Indonesia is a country where law enforcement at times leaves room for interpretation and bargaining on the principles of common sense. In the microfinance sector the overriding culture seems to be that non-regulated entities can continue to operate in grey areas fairly untouched and only face legal challenges when problems pop up in their operations and attract public attention. It does constitute considerable institutional risk nonetheless; for them as well as, by implication, for their donors, lenders and supporters.

Program-based microfinance is largely a public sector form of microfinance that uses credit delivery as a tool for accelerating development of the lowest strata of society. The main issue is that resource allocation to these strata is indeed much needed and appreciated but that the instrument of credit delivery may not be the most appropriate if a program loan is widely perceived to be an actual grant. There indeed is a substantial tradition in this area.

²⁷ A senior executive at a major commercial bank still has time to manage a chain of cooperatives on the side that provide small loans (IDR 1 million or EUR 71) to be repaid in 67 daily instalments of IDR 20,000. These cooperatives do not have real members and do not collect savings. Loanable funds are financed by the manager's own resources and those of some co-investors on the basis of promissory notes issued to them. The country knows quite a few of such 'personalized coops'. Other smaller coops do collect time deposits from the general public offering interest rates almost as high as in the formal banking sector. Net interest rates are much higher though as the coop deposits are not subject to withholding tax. At the same time these deposits are not covered by deposit insurance as they are not provided by regulated deposit taking institutions.

Promoters of best practice microfinance also instigated a lobby and advocacy effort to convince the Government to abort such practices. And in February 2004 a milestone was thought to have been reached by the signing of the so-called Yogyakarta Communiqué where the central bank governors and senior officials of ministries of finance of ten Asian countries, amongst others, pledged:

“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”.

Whilst the promoters of best practices microfinance heralded this pledge as a major step forward by pointing at the first sentence, promoters of program-based microfinance got all they wanted to continue their line of activities by pointing at the second.

The larger issue at stake here is that Indonesia has established a strong *public good* concept and practice in microfinance that may indeed not be market-driven but also can not be easily abandoned as that is considered socially undesirable and politically unattainable. Moreover, there is growing evidence that subsidized microfinance does not necessarily undercut a good credit culture at large. Indonesian clients are by and large well able to distinguish between a government loan and a genuine loan, and whereas they may feel encouraged to forego repayments on the first, they will still properly service the second. Lastly, even though the Government may not be able to withdraw from program-microfinance it can and does take steps to improve performance. Where credit evidently is considered to be a grant, today such allocations are increasingly treated as grants, as in the case of the targeted conditional cash transfers in major new development programs. And where it is supposed to be a loan indeed, management of the credit component is progressively out-sourced to competent financial institutions such as BRI and BNI.

3.3 Institutional Quality and Competencies

In the formal, regulated sector financial performance is generally considered to be satisfactory but this may conceal basic institutional weaknesses. Credit rating beyond the scope of commercial banks was only recently introduced to the sector and the first batch of results points out the more basic of these weaknesses; governance, management, systems and human resources in many cases leave ample room for improvement at BPR as well as coop and credit union level.

If it comes to governance, most BPRs have small boards, usually made up of the original owners/founders. A typical issue is that quite a number of BPRs was founded by non-profit organizations such as foundations with limited experience in supervising a shareholding company. Such BPRs often witness repeated and unresolved conceptual debates between social and business considerations. Another is that owners may consider their BPR as a private tool and find it difficult to distinguish between personal and institutional interests and responsibilities. Also the mutual sector is not free from challenges as regards governance. Decades of de-politicization and political patronage have severely undercut governance ethics and practices; the common practice more streamlined along the lines of larger dependency on an internal or external strong party. It takes time for members to learn to exercise their governance rights and responsibilities free from undue pressure. Overtime, however, at both levels improvements are reported, if only because of supervisory demand on governance quality. The main question remains if these improvements are introduced fast enough to meet requirements in the field.

As to management and HRD, BPRs find it difficult to find and retain qualified and reliable senior and mid-level managers. Real banking professionals generally prefer a career with commercial, especially international banks for reasons of status, income and career perspective. Moreover, the location of BPR offices may not reconcile with their professional standards. Though there is no lack of formally qualified banking staff to meet regulatory requirements, it remains a challenge to find professionally skilled and motivated staff for senior positions.²⁸

At mutual level the situation is different because coops and credit unions are supposed to be largely self-managed by members, also to keep overhead costs in check. The pitfall here is not only that especially in rural settings it takes time to educate members to become good managers, but also to install a proper management culture that keeps the mutual free from insider trading, favoritism and other undesirable practices. Again, over time such capabilities appear to grow but the pace is a moderate one. Many mutuals can use some outside assistance to accelerate the process.

Regarding systems there is great variety to be seen. Some BPR have installed cutting-edge management information systems whereas many others struggle with outdated, unreliable and inaccurate systems. Moreover, the investment capital to purchase state-of-the-art systems and budgets to hire staff capacity to run those professionally might be lacking. For many BPRs the intensive reporting requirements are a major burden rather than a push-on-a-button type of exercise. This makes them vulnerable. MIS and account department information may need to be reconciled every so often which not only constitutes a lot of work but also makes basic information unreliable and represents a risk towards future licensing. A major issue in Indonesia is that whereas in other microfinance markets MFIs can tap into larger support programs made available by the donor community, most BPRs can not. First because of the limited involvement of the donor community with for-profit microfinance in Indonesia, but also since technical assistance is increasingly only provided in conjuncture with international capital provision from which BPRs are statutorily cut off. Mutuals by and large face the same challenges in this respect.

3.4 Outreach

The outreach of the Indonesian microfinance sector is impressive but then again, Indonesia is a big country and the fourth most populous one in the world and the regulatory architecture does not really facilitate a larger civic sector-driven presence in the segments of the market untapped by formal banks.

This effectively leaves the servicing of the lower brackets of the economy to mutuals and government programs with all their pros and cons and whatever the appreciation of such programs, substantial white spots will remain intact in the years to come. At the same time there appears to be growing interest among reputed non-Indonesian non-profit

²⁸ A well-known local investor in BPRs, whose company has bought 26 of those in one deal, and meanwhile merged these into 14 well-performing entities all active in Java and Sumatra, for social-political reasons not so long ago opened an outlet in Makassar, South Sulawesi. Within a year he had to close the outfit and take his losses for the simple reason that he could not find properly qualified and motivated staff in the local market.

institutions to help fill the gaps, but they face the same and additional regulatory challenges.

Overtime, some efforts can be expected to slightly reduce the white spots on the maps in the current setting. Increased competition in the market will force regulated players to gradually descend in the market, and this process may actually be accelerated by the continued application of newly available ICT innovations in both front and back office operations. These will expectedly allow for further efficiency gains leading to decrease of operational costs which in turn can facilitate some downscaling in the market.

Nonetheless, other initiatives will be required to augment public and private sector capacity in servicing the lower brackets of the market. Whether that is possible or not largely depends on the legal ingenuity, operational creativity and strategic focus of operators and supporters genuinely committed to service this segment. The next chapter will discuss some modalities to that end.

4. MICRONED MEMBERS AND OTHER DONORS

4.1 Investment Overview

As per December 2006 the MicroNed members reported the following investments (in EUR);

Name	Grant	Loan	Guarantee	Status
Cordaid				
1. Purba Danarta			62,000	2004: ongoing
2. Bina Swadaya		132,889		1999: closed (repaid)
Bina Swadaya		71,302		1999: closed (repaid)
Bina Swadaya	222,047			1999: closed
Bina Swadaya		395,463		2001: ongoing (balance 154,545)
3. BMM		275,000		2003: ongoing (balance 130,612)
4. CUCO		235,000		2003: ongoing (balance 138,670)
CUCO	145,653			2003: ongoing
5. Ganesha		400,000		2006: ongoing (balance 394,115)
Hivos				
6. YPPWP	85,000			2004: closed
YPPWP	125,000			2002: closed
YPPWP	34,000			2005: ongoing
7. YPP	90,000			2002: closed
8. ASPPUK	35,000			2006: ongoing
ASPPUK	39,251			2006: ongoing
5. Ganesha	373,000			2004: ongoing
9. Pokmas Mandiri	196,700			2005: ongoing
Hivos Triodos Fund				
10. BDB		417,656		2002: closed
7. YPP		394,210		1999: ongoing (balance 159,607)
ICCO				
11. YPMD	200,000			2005: ongoing
12. Rumsram	50,000			2004: ongoing
13. KSU MS			16,100	2006: ongoing
14. SHEEP	12,720			2006: ongoing
Oxfam-Novib				
15. Peramu	311,190			2006: ongoing
16. Microinsurance Pr.	113,940			2006: ongoing
17. Pancur Kasih	97,167			2006: ongoing
18. Puti Jaji	21,732			2006: ongoing
Totals	2,152,400	2,321,520	78,100	
Average per partner	195,673	464,304	39,050	
Average per contract	126,612	290,190	39,050	
Average per donor	538,100	580,380	19,524	

This means that overall 18 institutions have been supported over the last years until the beginning of 2007: 2 with guarantees, 11 with grants, 2 with loans and 3 with both grants and loans (one of which by different actors). Overall, the amounts of grants and loans provided tend to balance out, though average loans sizes are more than twice as high as average grants allocated per partner. Guarantee provision is small.

Loans are nearly exclusively appropriated for strengthening the capital basis of partners whereas grants usually are allocated for a variety of activities: capacity building, human resources development, networking, technical assistance and related overhead costs. Larger grant contracts may also include capital grants to grow the partner's (or its subsidiary's) loan portfolios in cases where debt finance was not considered to be an

option. In 2007 more approvals have been made but these data have not been fed into the MicroNed data base as yet.

Most of the partners were foundations; two a commercial bank (BDB, which in the meantime has been liquidated, and Purba Danarta); one a venture capital company (MBK, formerly Ganesha); one a coordinating body (COCU). More than half of the partners are active in retail microfinance; the remainder in capacity building, technical assistance or other forms of service provision to practitioners. Some of the foundations are owners or co-owners of microfinance institutions such as BPRs, either directly or by proxy.

4.2 Other Donors, Investors and Service Providers

The MIX Market²⁹ lists only five donors with a declared interest in Indonesia: Citigroup Foundation, Hivos, KFW, the Microfinance Alliance Fund and Rabobank. Presumably most donors include their Indonesia activities under more general Asian or global categories. Moreover, some donors are not listed under the donor but rather under the private investor slot. There are 17 of those with a (potential) interest in Indonesian microfinance: Cordaid, Dexia, Dignity, Gray Ghost, Hivos, HTF, KIVA, Microcredit Enterprises, MicroVest, Oikocredit, Partners for the Common Good, responsAbility, Rural Impulse, St. Honore, Triodos-Doen, Unitus and VDK. Public investors include Dexia and USAID Credit Gurantees whereas only Rabobank and KFW are listed as banks interested in the country. BISMA, in partnership with CARE International, is the only listed apex agency.

The MIX Market lists five so-called development programs/service providers: the Netherlands Government, Facet, LINKS Learning Center, MICRA and ProFI. Another five US-based agencies are presented as networks active in Indonesia: ACDI/VCA, CARE, CHF, GNBI and Mercy Corps. No ratings agencies are reportedly active in the country.

Information on the MIX Market is evidently quite incomplete if it comes to Indonesia.³⁰ The country actually has a genuine practitioner network (Gema PKM, hosted by Bina Swadaya) but its level of activities is somewhat erratic: it seems to fluctuate with the availability of (donor) funds. Besides, there are categorical networks as well in the form of for instance Perbarindo (Perhimpunan Bank Perkreditan Rakyat Indonesia, the Indonesian Association of BPRs) of which many BPRs are member. The cooperative sector has a national as well as regional cooperative bodies in BK3I (Badan Koordinasi Koperasi Kredit Indonesia) and BK3D (Badan Koordinasi Koperasi Kredit Daerah).

Syariah-based MFIs, usually operating under the name BMT (Baitu Maal wat Tamwil), in Aceh known as BQ (Baitul Qiradh), are well supported by Pusat Inkubasi Bisnis Usaha Kecil (PIBUK: Center for Small Business Incubators) a division of a foundation under nearly the same name (Yayasan Inkubasi Usaha Kecil) which is an initiative of the Ikatan Cendekiawan Muslim se-Indonesia (ICMI, All-Indonesian Federation of Muslim Intellectuals), the Majelis Ulama Indonesia (MUI, the Indonesian Council of Ulama's) and Bank Mu'amalat, the oldest and largest commercial syariah bank. The Center has

²⁹ www.mixmarket.org

³⁰ A look at the practitioner side only generates information on 2 banks (including BRI), 2 coops, 1 venture capital company (Ganesha), 5 NGOs, the largest of which with 28,000 clients (Tangerang), 1 under the category 'others' (BDB) and 7 BPRs as well as 11 LPDs listed as rural banks.

successfully worked with syariah MFIs to develop not only appropriate profit sharing distribution formats but also syariah-based insurance products (takaful).

The service providers with the highest profile these days are ProFI and MICRA. ProFI (Promotion of Small Financial Institutions) is a program established by BI, the Ministry of Finance and GTZ in 1999 to promote accessible, affordable and effective MFIs for low-income people. It worked at three levels: policy-making (macro), support infrastructure (meso) and training and capacity building (micro). It has been quite active in mapping microfinance at provincial levels and was at the forefront of the lobby for designing a special regulatory slot for Non-Bank Non-Coop financial institutions (NBNCs) to promote a stronger and legalized civic society involvement in the industry, as laid down in the draft Microfinance Act of 2002. The act did not make it and the program is presently winding up.

In a limited period of time MICRA (Microfinance Innovation Center for Resources and Alternatives) appears to have carved out a prominent place in Indonesian microfinance as a pivotal institution if it comes to pioneering innovations. Only established in 2006 by Mercy Corps it has quickly grown into a well-staffed and well-resourced Indonesian institution that diligently works on most of the hot issues in the industry. It introduced credit ratings at scale, has obtained a franchise license for marketing a state-of-the-art management information system for MFIs, works on establishing a training institution and, its flagship project, recently procured a commercial bank with other investors that will function as a Bank of Banks (BoB): a wholesale lending window for eligible MFIs that as an Indonesian institution can channel off-shore capital to the industry. It lives up to its self-proclaimed marketing strategy of providing a 'one-stop shop' for industry stakeholders. Its credibility in the market is shown by the many partnerships it rapidly managed to build with both domestic and international shareholders.

If it comes to taking stock of what other donors are involved with in Indonesia, it is nearly impossible to compose even a rudimentarily accurate overview. MIX Market data are incomplete and there is no national recourse center to consult. Yet there are some indicators. First, regulation and high liquidity in the domestic capital market considerably limits demand for foreign capital infusion. The Indonesian microfinance industry only marginally taps into the steadily growing international capital resource base earmarked for microfinance. What comes in is therefore small and largely follows the pattern followed by MicroNed members: capital grants and loans to selected non-profit entities such as foundations and mutuals to further build their loan portfolios and an incidental loan to for-profit MFIs for the same purpose.

Second, as the Indonesian industry is largely a home-grown one there is limited demand or space in the market for foreign donors setting up their own retail institutions. There are examples of those, usually pioneered by US or UK based so-called Private Voluntary Organizations (PVOs), often located in more remote islands, but their presence is quite limited. The more recent international trend to establish Greenfield banks has not arrived in Indonesia as yet because entry levels are very high (EUR 214 million in paid-up capital for a new commercial bank) and because their usual target market (SME lending in urban settings) is already well served.

Third, whereas Indonesian non-profits take little external capital, they have a need for straight grants for capacity building and technical assistance in many areas and particularly for strengthening service capacity in the lower brackets of the market. This comes in two ways: as in the case of MicroNed members in one-on-one formats, an

individual donor supporting an individual non-profit, and on a sector-based platform: various donors pooling their resources in order to serve many players simultaneously. There are not many examples of the latter category and there is little information on the former category for reasons mentioned. The total thereof is presumably not much higher than a factor four or five of what MicroNed members are bringing to the table for genuine microfinance capacity building.

The fact that for-profit MFIs, particularly BPRs, also have a need for capacity building is well-acknowledged but more difficult to meet because donors often shy away from working with for-profits (though less so if it comes to microfinance where corporatization of non-profits, transformation, is usually rather stimulated to meet regulatory demands) but certainly also because most donors have a preference to promote microfinance in the lower market brackets where BPRs are only limitedly active.

So whilst traditional donor funding to Indonesian MFIs is quite limited in comparison to other major Asian markets, there are various reasons to indicate that this might change in the coming years. First, the broadly shared allegiance to the United Nations' MDGs have brought about a renewed interest in stimulating the lower segments of the microfinance market in the most populous developing countries as the major vehicle to meet both quantitative and qualitative industry targets. This may increase global donor budgets for lower-end capacity building. Second, budgets of traditional donor agency are now exponentially augmented with budgets from new donor agencies in the form of the charities fueled by high net-worth individuals. The grant components of these new agencies are progressively made available for the microfinance sector and need to seek an outlet in the market.

Third, preparations are underway to host the next MicroCredit Summit Campaign for the Asia-Pacific region in Indonesia, probably in Yogyakarta. This will undoubtedly generate more interest in Indonesian microfinance in general. In addition, the executive director of the Campaign is increasingly beating the drum on the moral responsibility of the microfinance sector to reach the poorest clients, which will likely increase interest in strengthening the lower segments of the industry. Moreover, both elements can contribute to renewed efforts to come to a regulatory slot for NBNC institutional delivery formats. A same push to that end might be facilitated by parliamentary and presidential elections in the coming years, but that is hard to predict.

5. FUTURE-LOOKING STRATEGIES

5.1 Conceptual Considerations

Over the last decade the microfinance industry has shown strong growth: not only horizontally, more MFIs serving ever-more clients, but also vertically, upwards and downwards mobility in the market reaching both not-so-poor and poorer clients. At the same time a wide variety of institutional delivery formats has emerged. Next to early entry non-profits and mutuals, micro-financial services are now increasingly offered by commercial banks and all sorts of non-banking financial institutions. And also the scope of services has rapidly broadened from simple saving and loan products to pay-roll and consumer lending, SME lending, remittances, wholesale lending and insurance products.

This extraordinary development is often seen as a sign that the microfinance industry is rapidly coming to maturity, which is perceived to be a necessary condition for the next step in its anticipated development: recognition of the industry as a distinct asset class in international capital markets; that is an asset class that can do without subsidies or corporate social responsibility considerations to further grow, primarily driven by competitive return expectations.

For the purpose of this report two points of departure appear to be relevant in view of the above. First, Indonesia is a fine example of a country where the microfinance sector has evolved to its fullest possible width and depth. About all possible types of microfinance operators are active in the market, together covering the whole range of products and services thinkable. Second, the Dutch MicroNed members and their respective strategic allies have developed policies and investment and support products that allow for covering the full range of the spectrum. And even in cases where white spots could be detected or will appear in the near future, they are well positioned to tackle these in conjuncture with other players in the market, such as the other members of the Netherlands Microfinance Platform.

So on both sides of the institutional demand and supply side in principle there are ample opportunities to build partnerships, constituting a fairly unique proposition. However, quite a number of these opportunities appear to be constrained by regulatory, legal and capacity impediments which does not always allow for a quick realization of partnership building. It may require some unconventional approach to do so.³¹

The following sections will look into the identification of investment opportunities by way of segmentation of the market in various niches viewed from a demand perspective.

³¹ The case of PT Mitra Bisnis Keluarga Ventura (MBK, or Family Business Partners Venture Capital Company, more popularly known by its previous name Ganesha) is a good illustration of this point. MBK was established as a venture capital company to overcome the prohibitions of foreign ownership and off-shore lending of regular BPRs. But venture capital companies are now allowed to lend; they are supposed to provide equity investments to their clients. MBK got around that obstacle by setting up a profit sharing program. Today, even though it is foreign-owned and not legally engaged in micro-lending, it has built one of the largest microfinance portfolios in the country with nearly 60,000 clients, outnumbering most BPRs and showing much lower average loan sizes. Despite all obstacles faced, it has become what it aimed to be: a most efficient MFI focusing on the lower brackets of the market. MBK is also one of the few larger MFIs that apply the group-lending methodology

5.2 For-profit MSME lending

Commercial banks and BPRs have already built an impressive service capacity in this higher end of the market. Some largely restrict operations to SME lending gradually further creeping up in the market, few concentrate service delivery on micro-entrepreneurs in particular and most are truly opportunistic: they meet the demand as it presents itself as long as they can handle it prudently and professionally. The challenges in this segment are three-fold: low representation of the micro segment in MSME, low service capacity in rural Java and Bali and low overall service capacity in Eastern Indonesia.

MicroNed members aspiring to contribute to filling the finance gaps and not averse to working with for-profit MFIs could consider strengthening the handling capacity of BPRs willing to tackle one or several of these challenges. Assuming that such BPRs could be found, the first obstacle faced is that these can not directly attract off-shore capital that could be earmarked for such operations. The Bank of Banks construction pioneered by MICRA could potentially offer a way out here. As the BoB is an Indonesian commercial bank, even though it has 95% foreign ownership, including a 15% HTF share³², it will have no legal problems borrowing in international markets and distributing these loans to BPRs.

If not capital provision but institutional vision or capacity would be the main obstacle, MicroNed members can place TA funds with MICRA that plans to walk hand-in-hand with BoB investee BPRs. If the BoB would not be interested in addressing the challenges in its investment priorities, or not for the time being, establishing another BoB that would focus on such challenges could be considered. Exact replication of the BoB concept is not an easy solution any longer as setting up a new bank is prohibitively expensive and the window of opportunity for purchasing an under-capitalized existing commercial bank (as in the case of the BoB) has passed by as the new capital requirements for all commercial banks has become effective already in December 2007. There are not supposed to be any under-capitalized banks around any longer that could be purchased for reasons of getting a full banking license at low cost.³³ But it remains quite possible to establish a predominantly foreign owned venture capital company that places equity with BPRs and can provide or arrange for technical assistance as well. Such technical assistance, however, does not need to be channeled through a third party. One-on-one partnerships will remain possible as well. Particularly in the outer islands BPRs can be found with an aspiration to service the micro-end of the market but facing various obstacles making more work of that ambition in practice.³⁴

³² Other shareholders are Mercy Corps, KFW, IFC and the original owners.

³³ In that sense there is a certain missed opportunity in the selling of a truly micro-oriented commercial bank in the form of Bank Purba Danarta of Semarang, Central Java, well-known in MicroNed circles, to an investor whose intentions have not been clearly disclosed as yet as regards the future direction of the bank.

³⁴ The BPRs owned by YPPWP (Yayasan Pengembangan Prakarsa Wirausaha di Papua; Papuan Foundation for Entrepreneurship Development) are a point in case. Oxfam-Novib well over a decade ago made available seed capital to the foundation to set up these BPRs and at a later stage Hivos became involved with various capacity building grants. Plans appear to be underway to merge the three BPRs into a single entity (as initial geographical operational limitations requiring the forming of three of those are not valid any longer) and this could possibly be a stepping stone to enhance the new BPR's handling capacity. A double issue there remains in the form of the owning foundation facing the 25% restriction under the amended foundation's act and the need to bring in more capital. This is expected to be solved by bringing in more local shareholders in the merged BPR and by tapping into local capital markets for debt finance.

5.3 Civic Sector Microfinance

Looking at the combined MicroNed portfolio, NGOs in the form of foundations constitute the majority of grantee and investee partners, both retailers and support agencies. Of the latter, those involved in strengthening smaller NGOs active in microfinance with capacity building and placement of initial seed capital will presumably not have many problems in dealing with the amended foundations act as they are not in the business of asset building. Those that manage a network of microfinance outlets under their own aegis, such as Bina Swadaya, are more directly involved with the building of loan portfolios, but even here the legal issue might be of limited proportions as the assets are usually not their own: they work with borrowed funds and profits are not retained as assets but rather channeled to non-financial activities of the foundation. The same applies to foundations that are predominantly active in microfinance by using somebody else's capital. Their main restriction is that they are not allowed to collect savings from the general public; taking savings from borrowers appears to be acceptable as long as those are clearly registered as members' savings (similar to the situation in Bangladesh).

This observation results from an interpretation of the 25% clause in the foundations act. Foundations are allowed to engage in economic activities and actually own business corporations, as long as the volume of investments does not accede 25% of their asset base and as long as foundation staff is not employed in the corporations. This should not prevent foundations from borrowing and on-lending as borrowed funds appear as liabilities on their balance sheets. Seed capital and retained earnings realized over seed capital may, however, constitute a risk in terms of the 25% clause. If non-profits attract or build higher volumes of those they likely become vulnerable for scrutiny which can happen quickly as most development foundations have few other assets. But even then, they are likely to run into fiscal (capital or asset taxes) rather than licensing problems.

Besides the legal and fiscal issues, NGOs face capacity problems. It is difficult for them to hire banking or microfinance professionals, who usually rather work in a formal banking environment, particularly if it comes to senior management and back office positions. Moreover, their systems may be of substandard quality and governance is rarely applied based on strong financial supervisory skills. This makes NGO finance vulnerable for poor financial and institutional performance. At the same time they may score higher than formal banks on social performance if it comes to reaching poorer clients, rural penetration or serving the poor in more remote islands. At the end of the day, however, the possible trade off between financial and social performance is supposed to be a temporary one. Overtime high social performance has to be matched with (not substituted by) at least adequate financial performance.

MicroNed members do provide capacity building and technical assistance grants to their partner-NGOs, but are often too distantly involved to effectively monitor the quality and appropriateness of service provision. This creates a sort of potential quality trap: the facilities may be there but may not be effectively utilized across the board. In such cases MicroNed members have essentially two options to improve effectiveness: stronger direct monitoring and/or participation or outsourcing these fiduciary grant-making responsibilities as it were to competent third parties. The first requires an active and specialized presence in the field and the second the availability of such third parties which both represent challenges, to be discussed further below.

5.4 Mutual Microfinance

Cooperatives and credit unions have a potential ability to service poorer and more remote clients and many do. But also here a number of challenges has emerged: coops are quite often a far cry from the basic concept of being member-based, managed and governed, supervision is weak and ambiguous and systems and technical skills are often inadequate. Credit unions appear to be less vulnerable due to limited membership levels but that represents outreach and growth issues and, increasingly, liquidity management problems as members continue to save but after a while develop a lower appetite for intake of new loans. Moreover, the size of their operation is often considered too small for eligibility for one-on-one support provision by donor agencies.

There are cases, however, that show that linkage of credit unions can increase impact of the system. Combined size may now allow for designing support systems, liquidity management arrangements among a range of unions, and referral of more entrepreneurial clients to higher tier MFIs such as BPRs. This requires the availability of a third party in the form of for instance a support NGO.³⁵

As in the case of third party support systems in NGO-microfinance, also in the realm of mutual finance the number of high caliber support institutions is limited. This not only over-burdens demand on these third parties, but also leaves a large service gap in terms of further building NGO and credit union capacity to more intensively and better serve the micro market.

5.5 The Need for Interfaces

Following from the above, then, a clear and much needed investment area would be to strengthen what is called the *meso* level of the microfinance industry: intermediary institutions that can perform an interface function between supply and demand in the market. As argued before, both the supply and demand side are well developed but not perfectly matched. In some cases access to capital is a major interface function, but in many more cases the challenge is to improve quality and strengthen capacities and skills.

MICRA is a good example of a new interface that that will tackle a number of hot issues in the industry head-on and at scale. It will initially concentrate on the BPR and larger coop market, and, given continued adequate resource allocation, probably gradually expand into other niche markets. In the meantime, however, there remains an unmet need in these niche markets, particularly as regards the lower brackets of the NGO and mutual sectors.

This does not really call for more MICRAs in terms of equally well-resourced high profile organizations. The additional need comes more in the form of rural and outer island focused institutions with an intimate knowledge of these niche markets and a professional capacity to help improve non-profit handling capacity in place already

³⁵ Yayasan Pancur Kasih is a good example of such a support NGO in the MicroNed partner network. Operating from Pontianak in West Kalimantan, it works with a range of credit unions, totaling some 15,000 members, to improve standards; it runs a BPR in the same region and is very active in providing business development support, focusing on so-called people-owned rubber production and trade. As Pancur Kasih is a member of a string of Dayak NGOs, also including the Institute of Dayakology for instance, it can also address non-financial needs of the communities.

instead of setting up new retail outfits. That would be a less costly process of value addition.³⁶

In fact, some MicroNed members have supported third party service provision already in the form of support to, amongst others, Bina Swadaya, Pancur Kasih, YPP and YPPWP. It would be just a next step to build a sharper operational focus towards bridging identified service gaps and enhance their professional handling capacity in future partnership contracts.

Such a strategy would presumably be preferred over a more hands-on or direct implementation role by MicroNed members. A more intermediate strategy would be to link third parties to successful peers in the South or South East Asian region as well as with specialized technical assistance providers in the larger MicroNed network.

Of special relevance for Indonesia is the aftermath of not only the tsunami disaster in Aceh but also subsequent disasters in Sumatra and Java. In emergency and relieve operations microfinance is not generally considered to be an appropriate support mechanism. In later rehabilitation programs, however, often first steps are made to gradually move from grant to credit support and basic human and social capital is built to that end. Depletion of emergency budgets more often than not renders this capital under-utilized as no follow-up support can be made financed from more regular development budgets. It might be an interesting option to see what specific capacity has been built in this field and to what extent it would merit further support from the perspective of strengthening microfinance capacity in under-serviced areas.

If volume of activities would warrant, additional steps could be considered such as the organization of specialized training courses, common staff development programs, and even building a microfinance academy cum research and development institution specializing in pro-poor finance, preferably in cooperation with other interested donors and other actors working at the meso level of the industry.

5.6 Beyond Microfinance

If the focus is to be on developing microfinance in the Eastern islands of the archipelago the challenges are compounded by a great need for business development services. The more remote an operational market is located from the major trading hubs in the country (Jakarta, Surabaya, Medan and Makassar) the more difficult it is to find an outlet outside these local markets, some of which are actually closer to major trading hubs in other countries, such as Malaysia, Singapore, the Philippines and Australia. To off-set the costs of transportation of 'domestic export' and move beyond local markets, BDS can help MFIs identify products and services with high value addition potential and direct financial service delivery to these areas, whilst not shying away from financial investments in value addition facilities such as warehousing, processing or conservation of perishable

³⁶ A case that comes to mind is an East Java based rural development NGO that was quite active in boosting cattle production in NTT province with German funding support. Perhaps without fully realizing it, the NGO had built the nucleus of a rural microfinance program that with some specialized external support could grow into a genuine MFI: it had identified and trained the clients, developed financial products, arranged for veterinary service providers and built trading links. As donor support came to an end, however, the program was wrapped up and the NGO is now reportedly withdrawing from the province, leaving built human and social capital under-utilized. There are likely many more of such examples to be found in the NGO sector, including in post-conflict and post-disaster areas.

goods, transportation and marketing; either directly or in cooperation with other parties such as the formal banking sector or local governments. But that, again, does not only require capital but also profound technical skills to become effective.

Not only the area of BDS is a potential investment area to consider for giving more attention in the future (more, because some MicroNed members such as Cordaid have become involved already). Equally important is the development of new financial products, particularly as regards insurance and remittances. Oxfam-Novib has made a major first step in the field of microfinance by pioneering a linking and learning project to introduce new insurance products on top of the quite common credit insurance as well as life insurance by looking into health, calamity, crop and livestock products as well. Some fully licensed banks have tapped into the international remittance market already but mostly following expensive conventional distribution systems as those of international companies such as Western Union and Moneygram. Whilst the volume of international remittances is considerable, the domestic market is much larger and is largely serviced through the post office system which presumably has the largest distribution network in the country. The technical challenge is mainly to apply new transfer technologies such as internet payments or transfer through mobile phone technology to bring transfer costs down. The development challenge is to utilize income from remittances not for consumptive purposes only but move into community investments as well. The INAFI network of MFIs is launching a larger initiative to this purpose in 2008 and MicroNed members could link interested Indonesian partner organizations to this initiative as INAFI has no active members in Indonesia although Bina Swadaya and YPPWP are dormant ones.

If it comes to social performance assessment, there are currently various initiatives running simultaneously at a global level. One of those is the roll-out of a social performance indicator technology that reportedly can easily be included in management information systems and was developed by INAFI in cooperation with Dutch-based open source software house Ordina and Oxfam Novib. Initial ideas are to market this new technology on a franchise basis. Interested MicroNed partners could contact INAFI International or Oxfam Novib for further details.



ANNEX 1: RELEVANT LEGAL CONSIDERATIONS

Foundations Act (16/2001 and amendments and revisions)

- Art. 1: A foundation is a legal entity based on shared means established for the purpose of realizing specified objectives in the social, religious or welfare domains. Foundations cannot have members.
- Art. 3: A foundation is allowed to engage in entrepreneurial activities to achieve its objectives by way of founding or participating in business institutions.
- Art. 4: A foundation is not allowed to allocate proceeds (income) from business activities to advisors, management or board members.
- Art. 5: A foundation's assets in whichever form are not allowed to be transferred to advisors, management or board members and also not to employees or other parties that may have an interest in the foundation.
- Art. 7: [1] A foundation can establish a business entity the operations of which are inline with the purpose and objectives of the foundation. [2] A foundation can allocate capital in various forms to business entities, provided the overall amount is not larger than 25% of the financial means (assets) of the foundation. [3] Advisors, management and board members of a foundation are forbidden to assume board or management positions in aforementioned business entities.
- Art. 9: One or more individuals can establish a foundation by way of a notary deed in the Indonesian language. The foundation must be registered with the Ministry of Justice and Human Rights. A certain amount of funds must be placed as initial assets of the foundation. Founders can be Indonesian or foreign citizens.
- Art. 26: Foundations derive their income from initially placed funds, contributions, grants and other sources provided these do not conflict with the constitution and by-laws of the foundation.

Cooperatives Act (25/1992)

- Art 18: [1] Members must be Indonesian citizens. [2] A cooperative can have extraordinary members who are not Indonesian citizens.
- Art 24: Decision-making is based on the one-man-one-vote principle.
- Art. 34: Board members are personally liable for the institution's losses.
- Art. 41/3: Cooperatives are allowed to access bank loans, issue bonds, etc.

Government Decree on Cooperatives (9/1995)

- Art. 8: Management of a cooperative may be outsourced to another legal entity.
- Art.12: [For multi-purpose cooperatives:] the management of the savings and credit unit must be separate from the management of other units.
- Art 16/4: [For multi-purpose cooperatives:] the capital of the savings and credit unit must be managed separately from other units.
- Art.14/6: To protect the health of the organization a savings and credit cooperative is not allowed to pawn or mortgage its assets.
- Art. 17: Savings and credit cooperatives and savings and credit units [of multi-purpose cooperatives] can acquire their working capital from their members, other cooperatives or their members, banks and other financial institutions, issuing bonds or promissory notes and other legal sources.

Art. 18: Savings and credit activities are undertaken by and for members and candidate members or other cooperatives and their members whereas candidate members have to become full members at the latest within three months after placement of their first savings.

Decision by the Minister of Cooperatives (351/Kep/M/XII/1998)

Art. 3: If the meeting of members would decide that the business activities of a cooperative need to be developed, the cooperative's assets may be pledged or mortgaged provided this will not jeopardize the health of the cooperative.

ANNEX 2: THE PATCHWORK OF ACRONYMS

Arisan

The arisan is the most common form of social group formation in Indonesia. Members that come together on a social basis, usually once a month. Any kind of affiliation can be considered a good reason to form an arisan: residential proximity, mothers sending their kids to the same school, co-workers in the same office, students studying abroad and so on and so forth. Individuals can be members of several arisan simultaneously. Many arisan run simple small savings and credit activities: all group members put up some savings in their meetings which will then be collected by usually a single member who will repay the loan in a later meeting. Members can access the pooled monthly savings on a rotating basis, but in other cases more on a needs basis.

Small Village Level MFIs

The country has a bewildering number of predominantly smaller MFIs that work at village level. Essentially there are three broader categories of those whereas LDKP (Lembaga Dana dan Kredit Pedesaan, Village Capital and Credit Institution) is the more generic name for the various formats of village banks.

The first category consists of those stimulated by provincial governments and sort of supervised by the regional development banks (PBD: Bank Pembangunan Daerah) owned by these governments. These include for instance the BKDP (Badan Karya Produksi Desa, Village Productive Labor Institution) in West-Java, the BKK (Badan Kredit Kecamatan, Sub-District Credit Institution) in Central Java and elsewhere and the KURK (Kredit Usaha Rakyat Kecil, Credit for Small Entrepreneurs) in other provinces.

The second category is made up of organizations formed by the villages and usually owned by the villagers. These are for instance the LPD (Lembaga Perkreditan Desa, Village Credit Institution) in Bali and the LPN (Lumbung Pitih Nagari, the Pitih Nagari Rice Storage) in West Sumatra. LPD is known as the largest and best managed string of village-based MFI. Name patterns in this category are regionally specific. Besides the two mentioned, there are LKK (Lembaga Pekreditan Kecamatan, Sub-district Credit Institution) in West Java, BUKK (Badan Usaha Kecil Kedesaan, Village Small Enterprise Institution) in Yogyakarta, LKP (Lembaga Kredit Pedesaan, Village Credit Institution), in West Nusa Tenggara, LPUK (Lembaga Pembiayaan Usaha Kecil, Small Enterprise Finance Institution) and many others.

The third category is formed by village institutions whose formation dates back to colonial times and which are supervised by the BRI on behalf of Bank Indonesia. These primarily include the BKD (Badan Kredit Desa, Village Credit Institution) that operate all over Java and Madura. Typically BKD charge 3% flat to their borrowing clients of which 1% is paid to BRI for supervisory support and 2% remains with the institution.

ANNEX 3: PERSONS CONSULTED

Date	Name	Institution	City
29.11.07	A group of ten people	BPRs in Swadharma Group	Yogyakarta
30.11.07	Arum Riyana	Perbanas Jawa Tengah, BPR Mekar Nugraha Klepu	Semarang
30.11.07			Semarang
10.12.07	Dewi Prihati		Semarang
21.12.07	Lina Anggraini Amran	Makarim & Taira	Jakarta
22.12.07	Fx. Gunawan	Bank Purba Danarta	Semarang
26.12.07	Oni Rumaropen	Rumsram Foundation	Biak
26.12.07	Antonius Kose	Puskopabri	Biak
26.12.07	Isack Matarihi	Rumsram Foundation	Biak
28.12.07	Abraham Fonataba	BPR Phidectama Abepura	Jayapura
29.12.07	Decky Rumaropen	YPMD	Jayapura
03.01.08	Yuni Pristiwati	ASPPUK	Jakarta
04.01.08	Mulyadih	Yayasan Peramu	Bogor
04.01.08	Asadullah	Yayasan Peramu	Bogor
04.01.08	Bambang Ismawan	Bina Swadaya	Jakarta
04.01.08	Harya Sumarta	GEMA PKM	Jakarta
05.01.08	Ben Witjes	Hivos	Jakarta
07.01.08	Sidqy L.P.Suyitno	Bappenas	Jakarta
08.01.08	Dr. Shafiq Dhanani	PT MBK Finance	Jakarta
09.01.08	Meynar Sihombing	MICRA	Jakarta
09.01.08	Leesa Shrader	Mercy Corps	Jakarta
11.01.08	Ingrid van der Velpen	Oxfam-Novib	Jakarta
11.01.08	Panca Pramoedya	Hivos	Jakarta
12.01.08	Agus Rumansara,	YPPWP	Jakarta
12.01.08	Abdal Matin	YPPWP	Jakarta
14.01.08	Abidin Siregar	Swadharma Group of BPRs	Jakarta

ANNEX 4: RESOURCES

Economic and Social Development

Besides the material referred to in the footnotes, the World Bank site contains some other reports that discuss current issues, such as

- *Gender in Community Driven Development Project: Implications for PNPM Strategy*, Working Paper on the Findings of Joint Donor and Government Mission, composed by the Indonesian Government and several donor agencies, 2007.
- *Risk Behavior and HIV Prevalence in Tanah Papua 2006, Results of the IBBS 2006 in Tanah Papua*, Published by Bureau of Statistics and Ministry of Health.
- *Memerangi Korupsi di Indonesia yang Terdesentralisasi, Studi Kasus Penanganan Korupsi Pemerintahan Daerah*; by Taufik Rinaldi, Marini Purnomo and Dewi Damayanti, May 2007. English summary available under the title Combating Corruption in Decentralized Indonesia.
- *Unlocking Indonesia's Domestic Financial Resources: The Role of Non-Bank Financial Institutions*, December 2006, composed by the Indonesia Country Management Unit of the World Bank.
- *Baseline Survey - Executive Summary Women's Legal Empowerment*. This WLE is a program of the larger PEKKA initiative (Program Pemberdayaan Kepala Keluarga Perempuan, Female-Headed Households Empowerment Program), January 2007.

There is little in the way of updated information on HIV/Aids. Nearly all web sites devoted to these issues repeat the original UNAIDS 2005 figures but feature elaborate news sections with recent newspaper clippings. Information on gender issues is mostly presented in the context of on-going development programs supported by the larger bilateral and multi-lateral donor agencies active in Indonesia and can be found through their respective web sites under the Indonesia country entry. Also little additional information available on trafficking on specialized websites, except for recent news features. Providing a more overall overview:

- Kim Warren, *Trafficking of Women & Children in Indonesia*, September 2004, published by the International Catholic Migration Commission (ICMC).

Microfinance

Classics in terms of the long history of institutional microfinance in Indonesia are:

- Klaas Kuiper, *Act of Accident? The Birth of the Village Units*, 2003.
- Thomas Anthony Fruin, *History, Present Situation and Problems of the Village Credit System (1887-1932)*, 1933 (in Dutch); translated and edited by Klaas Kuiper in 1999.

If it comes to providing a more general current overview of microfinance, the score is remarkably low for a country that may rank as one of the largest markets in the industry. ADB some years ago contracted Chemonics Inc. to produce some country overviews from the perspective of pushing commercialization. The Indonesia study is:

- Stephany Charitonenko and Ismah Afwan, *Commercialization of Microfinance: Indonesia*, Asian Development Bank, 2003.

A brief but useful overview is provided by:

- Bayu Krisnamurti, *Microfinance Development for Developing Indonesia*, originally published in March 2005 in Media Informasi Bank Perkreditan Rakyat.

And a good analysis of developments of the regulatory framework is provided by

- Sumantoro Martowijoyo, *Indonesian Microfinance at the Crossroads, Caught between Popular and Populist Policies*, July 2007, published in CGAP's series on regulation and supervision.

The same author wrote the Indonesia chapters of a comparative study:

- Patrick Meager and others: *Microfinance Regulation in Seven Countries: A Comparative Study*, May 2006, submitted by the IRIS Center of the University of Maryland to the Sa-Dhan network in Delhi, India.

A convincing plea for coming to a distinct regulatory slot of non-profits is captured in

- Detlev Holloh and Hendrik Prins, *Regulation, Supervision & Support to Non-Bank Non-Cooperative Micro-Finance Institutions*, January 2006, published by the ProFI project.

If it comes to checking performance of regulated MFIs, the website of Bank Indonesia is the place to be: www.bi.go.id/web with the extension -en to directly arrive at the English language section. BI publishes monthly statistical overviews, also in hard copy, of the banks under its supervision.

Though the ProFI project is phasing out, its website remains well-maintained at www.profi.or.id. It features major newsflashes in microfinance and also has a quite unique regional overview of microfinance players. The Gema PKM website appears to be in hibernation mode, no entries since mid-2005, but it does contain the 2002 Draft Microfinance Act: www.gema-pkm.org.