AGENCY FOR INTERNATIONAL DEVELOPMENT
PPC/CDIE/DI REPORT PROCESSING FORM

ENTER INFORMATION ONLY IF NOT INCLUDED ON COVER OR TITLE PAGE OF DOCUMENT

1. Project/Subproject Number	2. Contract/Grant Number	3. Publication Date
497-0357	497-C-00-98-00045-00	June 17, 2003

4. Document Title/Translated Title

What I Learned in Indonesia: Nine Salient Points on The Indonesian Financial System and Small and Micro Credit

5. Author (s)

1. Thomas A. Timberg
2.
3.

6. Contributing Organization (s)

Nathan/Checchi Joint Venture/PEG Project

7. Pagination	8. Report Number	9. Sponsoring A.I.D. Office
25	PEG 121	ECG, USAID/Jakarta

10. Abstract (optional - 250 word limit)

11. Subject Keywords (optional)

1. Indonesia	4.
2. financial system	5.
3. small & micro credit	6.

12. Supplementary Notes

13. Submitting Official	14. Telephone Number	15. Today's Date
C. Stuart Callison, Chief of Party	011-62-21-520-1047	June 23, 2003

…...…………………………………………..……………DO NOT write below this line……………………………………..……………

16. DOCID	17. Document Disposition
	DOCRD [ ] INV [ ] DUPLICATE [ ]

AID 590-7 (10/88)

Technical Report

What I Learned in Indonesia:

Nine Salient Points on The Indonesian Financial System and Small and Micro Credit

By Dr. Thomas A. Timberg

peg

Prepared for:
USAID and Bank Indonesia

Submitted to:
USAID/ECG, Jakarta, Indonesia

Submitted by:
Nathan/Checchi Joint Venture
Partnership for Economic Growth (PEG) Project[1]
Under USAID Contract #497-C-00-98-00045-00
(Project #497-0357)

June 17, 2003

---

[1] PEG is a USAID-funded Project. The views expressed in this report are those of the authors and not necessarily those of USAID, the U.S. Government, Bank Indonesia or the Government of Indonesia.

What I Learned in Indonesia:

Nine Salient Points on The Indonesian Financial System and Small and Micro Credit

by Dr. Thomas A. Timberg[2]

What the Contract Says

My present contract prescribes:

"Incumbent [the Small Credit Adviser] will provide a final report addressing the research results, the analysis underlying the research, the recommendations that result and the rationale for those recommendations. The research, analysis, and assistance activities will also be reported to government officials through a national seminar that the incumbent will organize to consider findings and generate support for policy follow through." This is that report and that seminar.

The paper that follows is my summation, as you will see, in a relatively personalized fashion, since I think that will best serve the purposes of the wide variety of people here assembled.

I arrived in Indonesia, for the first time in my life in January of 1999 and was surprised by some of what I found. This is despite a professional lifetime of following the literature about financial system development especially for smaller clients – about the Unit Desa, but also other credit programs in Indonesia (several of these were surveyed for a USAID (United State Agency for International Development) inventory I co-directed in 1990, for example). I had also served as an adviser to an ADB (Asian Development Bank) study of Informal Markets that included a detailed study coordinated by Dr. Gunawan Sumodiningrat on Indonesia.

My Indonesian experience, however, confirmed my general belief that commercial credit run on market principles is capable of meeting most of the economy's legitimate needs for credit – and that while regulation is essential and not only for systemic and depositor protection – failures are more likely to be failures of regulation than failures of markets. Financial Markets can work well with only private participants, but non-profits and the government can have a positive effect when they take a pro-market stance. The BPRs (Bank Perkreditan Rakyat) are a good example of effective private sector intermediation, but the Unit Desa of BRI (Bank Rakyat Indonesia), and real credit

[2] Presented at a special seminar on June 17, 2003, at the Sari Pan Pacific Hotel, Jakarta, Indonesia. Formal comments on this presentation at the seminar by Abdul Salam, Bank Indonesia/Director of Directorate of Rural Bank Supervision, are attached.

cooperatives and credit NGOs (Non-Governmental Organizations) can be effective, provided they have the right orientation. I recently sent a protest to the journal *Small Enterprise Development* about their issue on commercialization of microfinance for neglecting the example of BPR, along with rural banks in the Philippines, and the old indigenous bankers in India (until 1990 or so) which show how local entrepreneurs can be included in, rather than excluded from, the development of local financial markets. The orientation of financial intermediaries has to include a commitment to financial sustainability and the preservation of their assets.[3] Almost all financial institutions, private or public, are fiduciaries of someone else's funds, and their employees are typically so as well. Financial institutions, private and public, are among those social institutions, essential to the preservation of capitalism, but whose focus cannot be the short term earning of profit. The contradiction they must face is to combine the search for profit, with a level of risk management that enables them to survive.

The leadership of the major types of Indonesian small financial institutions: BRI for the Unit Desa, Bank Indonesia for the BPR, and Menegkop (Ministry for SME (Small Scale and Medium Enterprise) and Cooperation) for the cooperatives have a fairly clear idea of what they need - and one with which I would generally concur. They have all had a remarkably hard time getting what they want because other groups in the policy process have blocked their progress for varying periods and reasons -- perhaps some of them correct. BRI has been constrained by various groups in the government, the BPR have been constrained, as far as I can tell, because of considerations having to do with the banking system as a whole and conflicts between sections of the bureaucracy, and the savings and loan cooperatives not the least because of their connection with the cooperative movement and politics as a whole. All three would benefit from a less political, more technocratic approach.

In what follows I shall outline what I think to be the most important facts about small and microfinance in Indonesia, based on my experience of the last four years

Situation in Indonesia

I. Small Credit in Indonesia has one of world's highest if not the highest permeation levels. Small Credit in Indonesia is Big and Pervasive.

The number of small scale enterprise oriented financial institutions is vast and bewildering from the networks of Bank Rakyat Indonesia both Micro and Retail, through the BPR, financial cooperatives, NGO and government programs, not to ignore the well run national pawnshops and the post office. Each of these has specific institutional and systemic challenges it most face, but together they serve a remarkable range of clients.

[3] Sustainability is now a "term of art," generally defined according to the standards of CGAP (the Consultative Group Against Poverty), as implying that the credit effort covers all of its costs including the what the "real," i.e. unsubsidized cost of its capital would be.

The numbers still often leave something to be desired in terms of accuracy. Despite the sophistication of much of Indonesian finance, the availability of financial system data is considerably less than in some other countries. This may be less of a problem in highly concentrated financial systems such as those that characterize much of Europe or even neighboring Australia, where the large-scale players have privileged access to the information they need. But the lack of accurate data is deadly in decentralized systems like the United States where the numerous players need information to coordinate their activities. Indonesia for small-scale finance today, is more on the American than the European side – responding I suspect to its greater size and social variation than many of the European countries. One would have thought that the civil law system might have constrained Indonesian variation by a concise specification of a limited number of permitted forms, but it has not. There are those involved in reforming the financial system in Indonesia who would like a more concentrated system (clearly not based on the good behavior of large Indonesian banks in the past) but I would doubt if they will be successful because of the general environment.

As I indicated in a paper entitle "Small and Micro-Enterprise Finance in Indonesia: What Do We Know?"[4] near the beginning of my stay:

"Indonesia has a remarkable variety of institutions providing small scale and micro credit formal, semi-formal, and informal and they handle considerable volumes of credit -- both in comparison to the size of the Indonesian banking system as a whole, in comparative perspective with other Asian countries."[5] Relatively current data on Indonesia is given in Appendix A showing that 10-15% of the population may be served versus 2-3% in Bangladesh.[6] Only 20% of lending is based on public savings there, whereas almost all in Indonesia is.

II. But market demand is clearly not yet saturated.

In the same 1999 paper, there is data, inter alia from the 1996 Economic Census showing that few Indonesian informal enterprises receive microcredit, only 15%.[7]

---

[4] Thomas A. Timberg, "Small and Micro-Enterprise Finance in Indonesia: What Do We Know?," delivered at the first PEG/ISEI Seminar in August 1999 which appears on the PEG website, http://www.pegasus.or.id/public.html.

[5] Appendix A contains a recent table recently prepared by Bank Indonesia . I also give some updates and an comments on the data contained.

[6] The sources for the Indonesian data are all cited in Appendix A. Paul B. McGuire, John D. Conroy, and Ganesh Thapa's Getting the Framework Right: Policy and Regulation for Microfinance in Asia says, p. 95 that there are 5.4 million microfinance borrowers in Bangladesh.

[7] A fuller discussion of the availability issue for SME, larger than microenterprises is contained in Timberg, "The Supply of Credit to SME -- Without the KUK (Kredit Usaha Kecil) Program," http://www.pegasus.or.id/public.html. This paper was addressed to the discussion of the decision

A more recent study by BRI and the Center for Business and Government at Harvard University, concludes:

"Even though BRI Units have done a remarkable job in extending savings and credit services throughout Indonesia, having captured a large share of the existing market, [our surveys] indicate that there is considerable scope for expansion of these micro banking services.[8]" The non-saturation of the market is also indicated by the rapid expansion of NGO credit programs, and the high profit levels in many existing MFI (Microfinance Institutions).

III. The steps needed to meet the unmet demand entail initiatives for each of the types of financial institutions that will permit them to expand. These initiatives in turn require increased investment in the institutions (usually many new entrants), competition, and efficiency. And all three are related.

I should note that the amounts of money involved even today are not trivial. BRI's Unit Desa currently has 12,5 trillion of credit, its Unit Retail 17.7. The BPRs have 6.8 trillion Rps of credit and 6.1 of public deposits (December 2002). The savings and loan cooperatives, and here the figures are weaker, have 4.1 trillion of credit. The pawnbroker, Pegadaian, has 1 trillion. The NGOs have a smaller amount of funds. But they are growing and serve many hundreds of thousands of clients. The program of BKKBN (Badan Kesejahteran Keluarga Berencana Nasional -- the Family Planning Agency) has the worlds' largest number of clients -- figures up to 10 million have been cited, though the individual amounts are small.

---

to abolish the lending quota for commercial banks, which is treated more extensively in an official Bank Indonesia document, *Penelitian Pelaksanaan Peraturan Kredit Usaha Kecil (KUK)*, Jakarta, Biro Kredit, Bank Indonesia, June 2000. Some sense of the approach of Bank Indonesia and its work can be gained in the paper, Timberg, "The Strategy of Financing SME in a New Economic Environment, http://www.pegasus.or.id/public.html, Fall 2000 The Banking authorities moved to an approach somewhat like that of the United States' Community Development Act and the stance of the Federal Reserve. Bank Indonesia as bank supervisor sponsors meetings between banks and potential small business clients to iron out obstacles to lending and requires the banks to publicize their small business lending figures to encourage them to do more of it. In addition, at the highest levels Bank Indonesia has also sponsored meetings with the "significant" large banks at which they were encouraged to increase their small scale lending. Such lending has increased considerably, though it is still concentrated in a few banks and constrained as I will show latter by operational factors. The theoretical framework here is contained in Timberg, "Why Isn't There More SME Credit From Commercial Banks in Indonesia," and "Lending Models -- How Relevant -- Why SME Loans Are Made in Indonesia," http://www.pegasus.or.id/public.html, November 2000. The research proposed in these papers was implemented as a study of Bank Indonesia, but the results are not yet released publicly. Some of the conclusions are included in this report without citation.

[8] PT Bank Rakyat Indonesia and Center for Business and Government, Harvard University, "BRI Micro Banking Services: Development Impact and Future Growth Potential," NP, October 2001.

1. For the BRI Unit Desa, clear expansion plans need to be implemented with new investment. The responsibility here lies with the government as BRI's owner to plow back some of its earnings rather than treat the Unit Desa as a cash cow as it now does. This will be a far more effective investment than almost any other proposed use of government resources in increasing small credit availability. Then the government should make the commitments and investments which will enable extending the range of BRIs activities -- through encouraging the expansion and reform of the BKD (Badan Kredit Desa) network and similar down market extensions of BRI. These extensions outside BRI itself are necessary because BKB can charge their full higher cost and are lower cost, and BRI itself would be reluctant to charge smaller borrowers more than it now does. At the other end of credit spectrum, the revival of the BRI Unit Retail would make a major contribution to finance for SME (Small and Medium Enterprise), but there are clearly serious internal obstacles that need to be cleared inside BRI. Other people connected with BRI itself and the Harvard Group have done the primary work on this subject and the detailed discussion here belongs to them.

Obviously, commercial banks other than BRI can and should help meet the needs of the market. Unfortunately, most of them are responding in bureaucratic, non-commercial ways because they do not believe that they can make a profit out of serving the bottom of the market. There are exceptions and these should be encouraged. Several larger banks have launched microfinance efforts -- but many are too oriented to social goals, and insufficiently commercial in their orientation. One can predict that they will be limited, and perhaps eventually collapse.

One particular group of interest is the small, so-called "Class A" banks that do primarily serve smaller borrowers. While being held to the strictest prudential standards these should be encouraged -- and other small locally focussed banks should be permitted -- rather than discriminated against as is urged in various Blueprint drafts for the banking sector. It is interesting that these Class A banks which are the heroes of the Monetary Crisis are being punished in its aftermath. I wrote a memo last year on "Why Small Banks are Beautiful in Indonesia," using both comparative and Indonesian data.[9]

In addition, commercial banks and other larger scale investors might make some money lending to BPR -- particularly at present 18-21% rates. The planned creation of an independent, credible Indonesian rating agency for BPR should assist not only Indonesian banks, but private investors, and foreign funders to invest in BPR. Unfortunately, with the large amount of funds that will become available to BPR under the presently proposed linkage program with commercial banks, planned to go into the trillions of rupiah, it is questionable how much pressure for increased credit quality there will be.

The involvement of commercial banks with the mass market, consumer but to a lesser extent small-scale business finance, will be enabled by the creation of a Credit Bureau

[9] Thomas A. Timberg, Are Small Banks Beautiful in Indonesia?," http://www.pegasus.or.id/public.html, February 2002.

analogous to DataAdvantage in Australia or Dun and Bradstreet, Equifax, and Transunion in the US. After a period of delay the formation of such a Credit Bureau is now going forward under Bank Indonesia sponsorship. I might point out that in the United States one of the major sources for small, start up finance, are balances on the personal credit cards of the entrepreneurs.

It is not to be expected that all commercial banks will serve the mass market, but a lot could make money doing so whether directly or through BPR or using NGOs as Self-Help Groups.

However, particularly for the smaller borrowers other types of non-bank MFI are likely to be important.

2. The BPR have considerable potential in most areas as evidenced by the very high profitability of many of them and their willingness to pay rates like 19-21% for money.[10] Many new investors are interested but the process of getting a new license is complex and time consuming but is now being streamlined. The expansion of BPRs will require much more capital investment. For those BPR that are publicly owned, this can unfortunately only come from their financially straightened local government owners. Thus one useful reform would be to figure a way in which these public sector owners could access outside, probably private equity funds. For privately owned BPR, there is a need for a much more liberal approach to licensing new BPRs and increasing the capitalization of existing ones. The scheduled availability of funds under the linkage scheme presupposes a rapid expansion of BPR activity. Except for the possibility of foreign equity, this is primarily a matter of regulatory policy by the bank regulators.

The process of BPR expansion will clearly be facilitated by a regulatory tightening that will increase their public credibility. It would also help if government BPR deposit guarantees were paid more swiftly and therefore were more credible than at present. Most of the needed regulatory reforms are already on their way to enactment -- but are still held up by delays in the general process of bank regulatory reform.

[10] Those interested in the state of BPRs have a considerable literature to consult including several studies sponsored primarily by Bank Indonesia and the PROFI Project. Inter alia, see "Penelitian Faktor-Faktor Dominan Keberhasilan BPR Dalam Pengembangan Usaha Kecil di Wilayah Jatim, Bali, NTB dan NTT," Bank Indonesia, Surabaya, October 2002. The PROFI study is cited later in this paper PEG has co-sponsored two best practices studies and a study of turnaround management by IBI (Institute Bankir Indonesia), see http://www.pegasus.or.id/public.html. See also Proceeding Makalah, Lokakarya Pengembangan Lembaga Keuangan Mikro, Yogya, February 2000. The two best practices studies have not been posted as of this delivery and are still with IBI. An English summary of the turnaround work is available at the Pegasus website in the form of a Jakarta Post article, Thomas Timberg and Sukiswo Dirdjosuparto, "Opportunities in the Banking Quagmire," October 2001 and the case studies on turnaround management: Sukiswo Dirjosuparto and other IBI Staff, "Manajemen Strategi Turnaround, Studi Kasus: Bank Perkreditan Rakyat di Jawa Tengah," July 2001.

The regulatory reform of BPR (and the deposit insurance scheme for them) will not be possible until the affairs of the relatively large number of troubled BPR are settled. It is impossible to have healthy competition if the field is still cluttered by banks which "have nothing to loose" from inefficiency. Bank Indonesia has been moving systematically to resolve the problems of these BPR and needs as much support as it can get from donors and others.

USAID, through the Asia Foundation has been supporting a restructuring effort in JABOTABEK. GTZ through PROFI has been undertaking similar efforts in Bali, East Java and elsewhere. Several NGOs like UKABIMA and ACDI/VOCA have undertaken particular collaborations with troubled BPR. But other opportunities exist where proprietors and the local authorities are willing to collaborate.

The flourishing of BPR also requires the development of an adequate supporting infrastructure. The rating agency referred to above is one such piece of infrastructure, as is the creation of pooling funds. The imposition of professional standards on BPR personnel and the provision of training which has developed so successfully in some regions especially East Java and Bali, needs to be spread throughout the country. The increasingly important role of external audit for BPR, by Akuntan Publik requires the development of professional standards and expertise that does not yet exist. I am happy that the Case Studies on Difficulties in External Audit of BPR which USAID supported are now being used in training -- but that represents the beginning rather than the end of the process of professional development.[11] It is still too frequently the case that BPR audits are "once overs," missing massive frauds and gapping holes in the balance sheet. CGAP (Consultative Group Against Poverty) stands ready to provide technical assistance both in training and upgrading accountancy, and Indonesian institutions would do well to take advantage of their offer. Unlike many other donors, CGAP is relatively passive and requires aggressive pursuit and follow through by Indonesian partners.

BPR will also be helped if they can have access to the Credit Information Bureau. Obviously, the larger the range of credit providers whose data is included the more effective will be the Credit Bureau. In many countries, retailers and utility companies are key sources and key resources for credit analysis. Most companies start stretching out their bill paying long before they default on bank credit.

3. The savings and loan cooperatives, which represent almost as much assets as the BP, are in more troubled state.[12] Their prudential supervision has collapsed since

[11] These studies are still undergoing final editing and have not been posted on the PEG website. Not unsurprisingly they reveal considerable fraud by bank employees and the possibility of detecting that fraud through relatively routine auditing techniques. I append a short summary of the case content as Appendix C.

[12] Timberg, "Savings and Loan Cooperatives," for the orientation of a national study, now completed on the Peg website, http://www.pegasus.or.id/public.html. Laporan Seminar Akhir Studi Pengawasan KSP/USP Dalam Rangka Pelaksanaan Otonomi Daerah, Jakarta, 30 September, 2002.

provincial decentralization, and many of them are quite inefficient. But, in fact, the state of supervision is so poor that no one really knows how serious their situation is. Nonetheless, many credit cooperatives are thriving, such as some of the credit unions. They have inherent advantages in low overhead and cost, provided they focus on local level finance among clientele they know and who know them. The same more or less applies to the thousands of BMT (Bait Mal was Tamwil)(Also BTM, the Bait Tamwil Mal associated with Muhammadiyah) or Islamic savings and loan cooperatives, to say nothing of a whole world of "pre-cooperatives," informal cooperatives etc. These are clearly a feature of the Indonesian small financial scene that is here to stay -- but their legal status is uncertain, and they present serious prudential risks especially as many of them hold billions of rupiah of public funds.

The State Ministry for Cooperatives and Small Enterprise is involved in two initiatives at the moment with considerable potential to help the cooperative sector. One to launch a pilot regulation and development effort in the regency of Jember in East Java, and the other to draft, and one hopes pass, a separate Savings and Loan Cooperative Law.

A larger issue is the thousands of pre-cooperatives, Islamic savings and loan cooperatives (BMT), etc. most of them connected and some registered with the various local cooperative offices (Dinas) but subject to even less monitoring. Related issues pertain to the several thousand LDKP (Lembaga Dana Keuangan Pedesaan), locally owned credit institutions in the provinces, and the Badan Kredit Desa, which serve as an adjunct to BRI. All of these MFI clearly serve a purpose but exist in a regulatory and policy vacuum, and are thus dangerous loopholes through which innocent depositors can be defrauded of their savings. Various local initiatives, including the one cited in Jember, exist to address this problem, but its resolution is still not clear. A proposed Microfinance Institutions Law, now in the Ministry of Finance and being prepared for submission to the parliament (DPR - Dewan Perwakilan Rakyat) would help.

4. The impressive state pawnbroker, Pegadaian, needs to be permitted to expand. Somewhat as with the locally owned BPR, ways need to be sought to permit it to access private equity. And like those BPR legal reform would be required to make such investment possible. According to its own data, 69% of the pawnbrokers' funds are used for business purposes.

5. Shariah financial institutions may not require separate statistical treatment, since they are supposed to be covered in overall financial data. Nonetheless, given the history of mismanagement in previous Islamic credit efforts it is essential that the Islamic clientele not be cheated this time, and that honest and efficient systems guarantee them the same security as non-Islamic borrowers. The Shariah Bureau of Bank Indonesia has made some very creditable progress here, but will be served by close cooperation with the Islamic Financial Services Board (IFSB) in Kuala Lumpur and the IMF (International Monetary Fund) which are working to develop appropriate regulatory systems for Islamic finance. The self-regulatory efforts launched by PINBUK

(Pusat Inkubasi Bisnis Usaha Kecil) for BMT and other PINBUK efforts to professionalize BMT represent very useful initiatives.[13]

6. A great deal of NGO credit already flows through channels that have been described above -- but a number of large programs do not, and quite a number are connected with Yayasan, whose status in credit matters is certainly at doubt given the new Yayasan Law. The AKM (Asosiasi Keuangan Mikro) initiative, to which USAID has been able to make some contribution, is an attempt at benchmarking and self-regulation for some of these NGO programs which has some promise. It is to be hoped that a broader group of NGOs can be included in this effort.

IV. The precise institutions which are important differ between the different regions of the country, depending on their institutional history.

In West Kalimantan, Bank Nasional Indonesia and the credit unions are critical, and opportunities for expansion of BPR are considerable. BRI is less important. In other regions, BRI and the attached BKD dominate the picture. No "one formula fits all" can handle the development of Indonesian financial institutions. In West Java, all financial institutions seem weaker than in Central and Eastern Java. I again refer to the beginning of an effort which I made to study the situation in several provinces the results of which are posted on the PEG (Partnership for Economic Growth) website. Similar studies have been completed by PROFI and the Asia Foundation/Harvard Group.[14] More would be useful.

V. Most of Indonesian Microfinance is commercially sustainable -- it covers all its costs including costs of funds. This is very important, because without this sustainability it would have to be much less extensive.

I note that a few MFI are beginning to give CGAP (the international standard), sustainability figures when they report their activities. The proposed CGAP institutional disclosure standards deserve consideration but may require some adaptation to Indonesian circumstances.

---

[13] There are several articles posted on the PEG website http://www.pegasus.or.id/public.html dealing with Islamic institutions in Indonesia. I would also recommend the recently released Blueprint for Islamic Development in Indonesia, January 2003, which is available on Bank Indonesia's own website, and a paper from a recent Washington Conference which is in process of being posted to the Pegasus website. Also "Kebijakan Pengawasan BMT; Sebagai Bagian Dari Lembaga Keuangan Mikro", PINBUK (Pusat Inkubasi Bisnis Usaha Kecil), Jakarta, 2002.

[14] Detlev Holloh, Profi Microfinance Institutions Study, PROFI, Denpasar, March 2001; Presentations at Seminar at Hotel Gran Mahakam by Asia Foundation and Harvard Group, May 8, 2003.

VI. Nonetheless, this sustainability is less characteristic of the very lowest levels of microcredit. Nonetheless, low-end microcredit is particularly important from a social point of view.

The lowest levels are important however, since it is concerning these levels, under $100 or even $50 US loans, that Morduch and Morley question whether commercially sustainable microcredit is possible.[15] Everyone agrees that even if such credit is not completely self-supporting, it should perhaps be provided on a lightly subsidized basis because of social benefits that result.

Some of the low-level programs in Indonesia, e.g. Dian Mandiri, do provide unsubsidized credit but the rates they need to charge can be 48% (in their case) or higher in others. The programs supported by Mercy Corps which are subsidized through the provision of initial loan funds, often find themselves charging similar levels set autonomously by the members. It should be noted that there is heavy demand for this credit, and these rates are frequently not set by sponsors but are the rates that small, mutual community organizations themselves set. That is, they probably reflect the scarcity value of credit for their customers. On the other side, there are those who wonder if clients are being assisted by being encouraged to borrow at these rates. Many of their clients' activities, especially in trade do have high margins.

There is clearly a research agenda here, to assess how these credit programs assist in meeting the problems of their poor clients. There has been some Indonesian discussion of this issue, which is not well known outside of Indonesia.

VII. Further, the dependence on deposits means that Indonesian small and microcredit pose serious dangers from the point of view of depositor protection.

The number of clients and sometimes amounts are large, and the potential for causing flight from the financial system real. As the Senior Deputy Governor of Bank Indonesia says, the good majority of his home village are in the Mosque praying on Friday, but there are always a couple of enterprising types willing to steal bicycles parked outside.

[15] Jonathan Morduch, "The Microfinance Revolution," *Journal of Economic Literature*, December 1999 and Ed. David Hulme and Paul Mosley, *Finance Against Poverty*, 2 vols. London: Routledge and Kegan Paul, 1996,

VIII. There is a clear need for safe deposit and remittance facilities in isolated areas. Many of the small microfinance programs have problems locating a place that will hold their cash. In this respect, Indonesia is somewhat behind both South Africa and Latin America where a number of innovative approaches permit effective remittance and deposit throughout the country.[16]

IX. Everything I have said applies to SME finance as well as microfinance – but as we reach that subject certain aspects change. A Systems and Procedures Analysis enable us to isolate the checkpoints in the expansion of SME credit.

For SME larger than microenterprise, the role of commercial banks is dominant, with some development of finance company financing, especially of leasing of motor vehicles. The amount of finance available may be somewhat smaller as compared to the demand than microborrowers – though even that fact is not clear. But commercial banks in Indonesia are less commercially oriented, because more bureaucratic, than many of the actors in the microfinance market. The vast bulk of commercial bank assets are directly or indirectly controlled by the government and highly responsive to its initiative. It is especially the smallest banks which behave like commercial enterprises.[17]

More generally, a study of commercial bank SME lending conducted by the Adviser in connection with others came to the following conclusions:

Commercial banks treat program funds from outside sources entirely separately from their own funds and typically do not concern themselves with the credit worthiness of borrowers under those programs.

Since program funds are constrained and have been relatively ineffective in promoting enterprise -- the expansion of commercially motivated retail (i.e. non-program) lending would seem the way to expand small and medium scale lending. In the banks' terms, this lending is included within the retail lending category which is usually much wider than the official SME definition. Typically, retail lending is any loan of under 5 billion rps, the official definition of SME lending is any lending of under 500 million rps which conforms to certain other restrictions.

Fortunately, the commercial strategies of many banks commit themselves to expanding this retail lending, demand seems buoyant, and the increase in such lending appears to be occurring. The most obvious obstacle to increasing retail lending is that despite

---

[16] An article on this subject is posted on the Pegasus website.

[17] This may seem a bit extreme, but it is confirmed by an unpublished study I did with Bank Indonesia, where the actual procedures for credit were highly responsive to central office bank policy and that in turn to government leadership – and no banks surveyed systematically worked out the profitability of their various lending activities – though several of the smaller banks did so in rough and ready ways.

committing themselves to expand retail lending several large banks have not translated this into imperatives for their employees and do not provide them appropriate systems and incentives.

Those banks that sincerely want to increase their retail business lending in Indonesia do not seem to have problems doing so. It requires a policy commitment by the bank, with appropriate incentives for staff. This is even the case when the procedures involved appear to be cumbersome by international standards and require documentation that seems excessive and unneeded.

On the other hand, despite the existence of nascent scoring systems in some commercial banks, banks did not seem to have developed standard methods for analyzing and approving small business loans, but prefer to rely on the business judgement of their lending officers, reviewed by a credit committee. Most banks appear to make little use of their own data in deciding credit policy. The Class A banks did indicate that they made active use of the Bank Indonesia Debtor Information System.

Interested banks, might be to standardize the techniques for evaluating the accounts of loan applicants (in terms of accounting ratios), and verifying the standards against lending experience.

The constraints on lending because of exacting collateral requirements may partially reflect regulatory constraints, though most bank decision-makers felt that these constraints were desirable. It is not clear that any system of guarantees will relax these constraints, unless parallel changes in regulatory norms are undertaken. In general, a good deal of what banks do is connected with window guidance and perceived window guidance from the supervisors, although documenting this guidance in Indonesia is difficult.

Summary Thoughts

To summarize, Indonesia has an extensive financial system but:

A. Pressures for rents and giveaways are continuous. And could always undermine what is there through providing cheap money and destroying institutions.
B. Protection of depositors is limited. So depositor confidence is at risk.
C. Efficiency is low – one factor leading to relatively high margins. The other is the lack of competition – and the two are undoubtedly related.

All three are worldwide problems but the size and usefulness of Indonesian small-scale finance make them more threatening than elsewhere.

At this point everyone probably expects recommendations. Some recommendations have already been made in the text of the paper and Appendix B is an index of these.

The present and proposed regulations for the system are by and large right. They certainly could use tweaking. They are still too biased against competition. They leave some dangerous loopholes – but they are by and large right. One of the major loopholes is the existence of some relatively large institutions taking public deposits that are not subject to any external supervision or regulation except by the market. Experience throughout the world has shown that this is a recipe for disaster. The 67 BMT with assets of over one billion Rps and the cooperative credit system in general is a disaster waiting to happen. In fact, mini disasters among cooperatives have occurred with some regularity.[18] But the greater problem, connected with the confusion connected with the movement to a more open and decentralized regime in general, is the lack of efficient and effective enforcement. Even for BPR, full enforcement is still not complete and the deposit guarantee system imperfect.

Efficiency levels are still too low. In the last decades, small and microfinance have been professionalized and management tools developed for them that are still too little used in Indonesia.

One critical need is for more available financial statistics. Most of the data is available and even fairly accurate, but not enough is released in easily accessible form. Bank Indonesia does no regular release of its data on the sizes of credit limits, for example. There is clearly a paying market for this data, and the amount that is released -- such as the quarterly bank returns are useful (though not always posted in a timely fashion). Incidentally, the detailed BPR data is not easily available on any terms -- but must be collected Bank Indonesia branch by Bank Indonesia branch. The data, as noted, for cooperative and smaller institutions is non-existent.

As an American, whose country has experienced more than its share of financial scandal and collapse over the last few decades, I can tell you that eternal vigilance in enforcement is required. Any relaxation and parts of industry let their desire for profit overcome their ability to manage risk. John Maynard Keynes said that the “animal spirits” of entrepreneurs were what drove economic growth, and indeed it does. But those spirits come in spurts of optimism and pessimism, which fiduciary institutions need to resist. As William Machesney Martin said, it is the job of the central banker to take away the punch bowl just as the party in the market gets going, but it is the job of all other bankers as well. I still remember a Latin American banker who always told his students that if they wanted to become very rich they had no business managing other people’s money. Moderation and moderate profit is what banking is about.

There is also a need for missing bits of financial technology – in many of which Indonesia lags neighboring countries – management software on the profitability of different banking operations, and a Credit Bureau with information on the credit history of smaller borrowers (the proposed rating agency for BPR, is a small scale adjunct to this kind of bureau). Efforts to move beyond this to credit scoring and sophisticated risk management techniques may presently overtax Indonesian data and the ability of those

---

[18] Bisnis Indonesia, May 6, 2003 p. 8.

who have to handle the task. Again technologies for remittance and deposit in outlying areas and for the poor are deficient.

But most important is the creation of a financial consciousness of the time value of money, of transactions cost, of the cost of bad debt and of risk management concerns. This consciousness is continually advancing but the country still does not have a sufficient number of domestic research centers for disseminating and developing this culture. I consider the development of that culture the first and most difficult task for the development of the Indonesian financial system to serve its clients, large and small.

The potential directions for further research are several:

Most are connected with detailed financial research about the actual systems and procedures of lenders and borrowers, what can be called "Systems and Procedures Analysis." This is data that is possible to collect, and in the case of lenders is often heavily documented. From this data should emerge benchmarks and best practices which will identify changes needed in those systems and procedures, as well as the extent to which expansion of credit and the economy is hindered by policy or overall economic constraints.

Too much financial research in Indonesia is attitudinal when it should be behavioral. It asks the opinions of actors, when the data of their actual performance is available and often corresponds poorly to their attitudinal response. Field studies show that behavioral questions can be asked and relatively accurate data secured The task of a financial sector researcher is much more comparable to that of an accountant than a public opinion surveyor.

APPENDIX A -- Micro-Finance Institutions (MFI) in Indonesia

Type of MFI	Total Unit	Number of Borrowers in Millions	Total Loans in Billions Rps	Average Loan in Thousands of Rps	Total Deposits in Billions of Rps
BRI Unit Desa[19]	3825	2.8	10300	3679	22400
BPR [20]	2141	1.82	6683	3672	6126
Village Credit Body (BKD)[21]	5345	.50	182	364	19
Savings and Loan Cooperative[22]	1097	.66	531	804.5	85
Savings and Loan Unit[23]	35218	NA	3629	NA	1157
Rural Credit Institutions (LDKP)[24]	2272	1.3	358	275.4	334
Islamic Credit Coop (BMT)[25]	3038	1.2	157	130.8	209
Pawnshop [26]	692	>15	973	NA	NA

Source: Bank Indonesia from various official sources. Latter figures from most recent data available with organization concerned.

[19] Data January 2002. As of April 2003, the number of borrowers was almost 3 million, total loan 12527 billion, average loan over 4 million, and total of deposits 24572 billion. In addition, in the Unit Retail (handling credits up to 2 billion Rps) there were 17700 billion of credit and 37326 billion of deposits. Unit Desa handle credits of up to 50 million Rps. (Source: Harvard Group at BRI)

[20] Data December 2002.

[21] Data December 2002

[22] Data April 1999.

[23] Data April 1999

[24] Data April 1999

[25] Data December 2002

[26] Data December 2001

In addition, considerable small scale lending is done by commercial banks and finance companies. As of November 2002, finance company lending amounted to 33 trillion perhaps half for commercial purposes (see Bank Indonesia Annual Report 2002). As of March 2003 the commercial banks were providing 174 trillion of commercial credit in credit limits of under 5 billion Rps of a total roughly 411 trillion credit outstanding. The latter figure includes roughly 40 trillion of non-commercial, channeled or program credit. That is, roughly 50% of commercial lending is in limits of under 5 billion Rps, and over 20% in limits of under 50 million. Eighty six trillion of this was in limits of under 50 million, 42 trillion between 50 and 500 million, and 47 trillion between 500 million and 5 billion. These figures are much higher than earlier figures and clearly include, inter alia, credit card credit. [Source: Bank Indonesia] Note Bene, on the basis of this data the role of BRI in extending microcredit shrinks considerably. An "eyeball" review suggests that BRI may account for about one half the number of microborrowers from government banks, and a small portion for the banking system as a whole.

Even so, the Table shows 23 trillion of credit and roughly 8 million borrowers, but this excludes cooperative and pawnbroker borrowers. One year the Family Planning Connected TAKESRA/KUKESRA claimed to have served 9.8 million borrowers, and it is reported to be the most extensive microcredit program in Asia. Some of the data is dodgy, and a little explicitly duplicative. For example, commercial banks extend credit to coops and BPR.

Appendix B -- Summary List of Recommendations

I. Better and More Prompt Availability of Financial Institution Data

A. Regular publication by Bank Indonesia of size classification of loans and deposits and number of accounts.

B. Availability of BPR data at national level.

C. Improved reporting and publication of data for other MFI.

II. For BRI

A. Invest in expansion of Unit Desa network, both in terms of number of units, geographic spread, and extension to new borrowers.

B. Improve outreach and efficiency of Unit Retail.

C. Establish and expand downward outreach through BKD, TPSP (Tempat Pelayanan Simpan Pinjam), etc.

D. Increase agricultural lending capacity.

III. For Other Commercial Banks

A. Enhanced commercial orientation toward retail lending through --
1. Improved staff training and incentives.
2. More policy commitment from management
3. Software, systems, and procedures which facilitate small lending and monitor its profitability.

B. For Small Commercial Banks -- Subject to stringent prudential supervision encourage expansion and new licensing.

C. Encourage and promote linkage scheme with BPR, and Self Help Groups on commercial and prudent basis. Nota Bene -- This will require rapid and prudent expansion of the BPR network and better credit information on BPR such as that provided by a rating agency.

D. Expanded Debtor Information System (Credit Bureau) preferably including data from non-bank credit givers including public utilities, and include even the smallest loans. It would be desirable if BPR could have access to this data.

IV. For BPR

A. Increase licensing and investment in BPR subject to strict prudential and fit and proper standards. Provisions for the use of foreign capital, especially from non-profits is particularly desirable. Possible two tier opening to permit licensing of lower capital level BPRs.

B. Create means to increase capitalization of PD BPR, including through injection of private capital.

C. Pay BPR deposit guarantee promptly.

D. Continue tightening of BPR regulation including new professional certification standards etc.

E. Close or resolve marginal BPR.

F. Provide support in restructuring and technical upgrading of BPR.

G. Create rating agency for BPR.

H. Improve training and certification for BPR.

I. Cooperate with CGAP on points G and H.

V. For Other MFI

A. Create effective regulatory and promotional frame for cooperative and syariah MFI. Present initiatives include Jember Pilot Project, draft Savings and Loan and Microfinance Institution Laws. Whatever is launched needs to be carried through. For syariah institutions some initiative is with the Shariah Bureau of Bank Indonesia and PINBUK.

B. Create loose but effective regulation of other MFI taking public deposits. The proposed MFI Law is meant to do this.

C. Increase capital of Pegadaian.

D. Spread CGAP Standard Reporting Standards on sustainability and disclosure.

VI Research Agenda

A. Conduct provincial level credit studies.

B. Research impact of low end MFI

C. Study various models of low end microfinance.

D. Research ways to improve remittance and deposit facilities for low end clients.

E. Research trends and factors in retail bank lending.

F. Continue behavioral systems and procedures research focussed on financial institutions.

G. Develop savings and investment survey capacity.

VII. Miscellaneous

A. Develop general finance consciousness

Appendix C -- Case Studies on the Difficulties Experienced in External Audit of BPR

The role of public accountants (Akuntan Publik) in external audit of financial institutions in Indonesia has been expanding. Though some of this is routine external audit (all companies worth more than 10 billion Rps must have an annual external audit by a public accountant), most of the audits of BPR are ordered by Bank Indonesia, the central bank and regulator of banks and BPR in connection with winding up troubled BPR. More than 70 such audits were conducted last year. These audits are obviously regulatory in focus and concerned with verifying claims. A small number of due diligence audits appear to be conducted in connection with the purchase or reorganization of BPR, these are obviously intended to be real due diligence audits. Nonetheless, few if any of these audits involve the field verification of sample liabilities and assets as might be expected for a financial institution.

Despite the number and the sanctions, the quality of the audits has been questioned, and the expertise of public accountants in conducting them is questioned as well. More than 100 public accountant firms have been certified by Bank Indonesia to conduct these audits and some have been deregistered for conducting unsatisfactory audits. External audit is also done by bank supervision personnel from Bank Indonesia. These audits are entirely regulatory, rather than due diligence or management audits. Many, if not most external audits do not have an explicit audit contract connected with them, and the nature of the certification implied is unclear.

Several initiatives have been taken to increase the quality of these external audits. Training has been conducted, inter alia by Institut Bankir Indonesia (IBI) and the Perbarindo Training Institute in Malang, to improve the quality of the audit personnel. Both to help develop empirically grounded training materials and to gather some data on the field conditions involved, a contest was conducted by Bank Indonesia, managed by a Working Group drawn from IBI, Perbarindo, Ikatan Akuntansi Indonesia, and Bank Indonesia, and supported by USAID for case studies written by auditors of the difficulties they encountered in the field in these audits -- the problems uncovered and the means for doing the uncovering.

Ninety-one case studies were submitted, unfortunately largely from Bank Indonesia supervisory personnel, despite some intensive publicity to the accountancy profession. Of these, a jury from the Working Group institutions selected 37 for editing and dissemination.

The cases concern what would be expected in terms of problems -- fictitious or improperly sanctioned credit to associates or even fictitious proxies for those sanctioning the credit, or the owners or bank managers, non-entry of savings deposits or loan repayments, fictitious expenses which were then pocketed. The frauds conducted were perpetrated both by lower level personnel and managers and owners. In the latter case, the motive was often the avoidance of income tax. Since BPR deal with many small borrowers and depositors they frequently use travelling agents who are obviously in a particularly good position to defraud both the BPR and the customer. Internal control systems at BPR are often weak, and at best highly informal. As small organizations single individuals often dominate decision-making. Interestingly, none of the cases really discussed the issue of internal accounting controls -- probably connected with the relative absence of accountants among the case writers. Exactly how common these problems are is hard to tell from the case studies, not the least because they are drawn from a sample of troubled BPR, but those with experience say they are quite common, as they are with Microfinance Institutions elsewhere in the world.

The problems were discovered in many fashions and many of the cases do not really explain how the problems were discovered. But the most common means seems to be careful study of the account books and corresponding receipts. In some case, the resulting cash shortages, public complaints, or informants were what called auditors attention to the problems concerned. To the extent routine audit is the primary tool for discovering fraud and monitoring internal control some more detailed treatment of the detailed audit measures concerned, the norms to check, the normal values of ratios etc. would be desirable. Discussion of field verification is called for.

“What I Learned In Indonesia”
by Tom Timberg (USAID/PEG)

Comments by Abdul Salam
(Bank Indonesia/Director of Directorate of Rural Bank Supervision)

Distinguished guests, Ladies and Gentlemen

It is a great honor for me to speak before all of you today. I would like to join other speaker to give some comment on Tom’s paper. I have prepared my statement in writing, to be distributed later

As a small credit adviser, Dr. Tom Timberg has made general correct statements regarding small credit issues and raised some initiatives to undertake research pertaining the following major substance. Despite his excellent points, to some extent, the paper still giving us some rooms for discussion and of course, clarifications on some issues for further elaboration. I will begin my comment on deliberation of the microfinance industry and end up with some strategic issues.

INDUSTRY OVERVIEW:

First of all, I will quote one classic statement made by Gonzalez-Vega/Chaves who says that Indonesia is the world’s largest laboratory on rural financial market experiments (I would say in term of types and size), with many different institutional forms have been tested by trial and error and valuable lessons have been embedded in the variegated experience of Indonesia’s rural financial markets, along a rich continuum of shades and shapes. Surprisingly, this conclusion was delivered by an expert from overseas, I believed after doing a research, since the internal parties are not so concern about this industry as we can see, for instance, from the slow progress in deliberating the draft of microfinance law.

Microfinance industry that consist of many players, either in term of microbanking or microfinance institutions (non banking microfinance), are strategic instruments/tools for poverty alleviation given the fact they have specific characteristic to serve the needs of the poor, such as group lending and joint liability as collateral substitute. Many types of MFIs in Indonesia, either formal or informal, that are scattered all over the country showing that there is no single form of MFI that fit to serve the needs of specific area.

It is clear enough that demand for microfinance is far from saturation. A baseline survey conducted in five provinces, Jakarta and greater Jakarta, West Java, Central Java, Eastern part of Java and West Sumatra concludes that competition in microbanking industry (rural banks or BPR) is still leave some room for other players in the industry. Other performance indicators, shows that the industry is consistently grow as indicates in 2001 and 2002 figures: 3.4% and 3.7% return on asset (RoA) and 20% and 25% return on equity (RoE). In the other side, BRI strategy to expand its offices also points out the condition that market is clearly not yet saturated.

STRATEGIC ISSUES:

How do we meet the unmet demand of the micro and small enterprises is another strategic issue that should resolve in a systematic way.

I will start the discussion with a strategy to increase the outreach by expanding the network of commercial banks with a window system approach. As stated above, BRI has already planned to open hundred units yearly, whereas PT Bank BNI is about to open micro service units (unit layanan mikro) in almost the same units. For BPR industry, Bank Indonesia also encourages investors, in many occasions, to established BPRs to serve the needs of micro and small enterprises.

Second strategy is to build the capacity of commercial banks, which will be accomplished in two different ways. Firstly by increasing the capacity of micro-entrepreneurs through engagement consultants associated with banks and narrowing the financing gap of BPRs by promoting linkage program between BPRs and other MFIs with commercial banks/other financial institutions. Secondly, is to build the capacity of BPRs in term of human resource through training with certification and information technology. To promote linkage program, I agree with Tom, that rating agency is crucial to achieve the sustainable program given that the agency will not only deal with providing information about eligible BPRs but also monitoring the program.

On the recommendation side, I agree with Mr. Timberg suggestion to improve BPR regulation. We, currently, are dealing with some improvement of prudential regulation, in line with best practice, such as capital adequacy ratio, asset quality, provision for doubtful asset and legal lending limit. Furthermore, there are also some strategies, which consistently carrying out in areas of restructuring the industry such as smoothing the blanket guarantee program; supervision; and empowering BPRs association as a part of building the infrastructure.

Since the issuance of new regulations on BPR, there are 64 proposals to establish BPRs coming from investors. After some time, 6 out of 64 proposals are granted operational license, whereas 18 granted principal licenses, 36 are being processed and 4 withdrawn by the investors. I think it is necessary to point out that process for licensing new BPRs is not complicated as long the investors met the necessary requirements and, of course this is free of charge. Investor need to submit proposal along with a feasibility study, prepared by an independent consultant, that takes into account many aspects in potency/saturation and eligibility of the new BPR.

For Village Credit Board (or BKD), Bank Indonesia recommends to exclude this kind of MFIs from banking industry due to reasons of not being operated as bank and not been able to follow the banking prudential principles, such as submitting regular report and providing minimum capital requirement. Based on its characteristic, it is better to put BKD as non-bank MFIs and, supposedly been supervised by BRI.

In general, technical assistance, either from CGAP or from other institutions, will make a significant contribution to develop MFIs as whole. The next crucial agenda is speeding-up the deliberation on microfinance draft law, which currently under discussion at Ministry of Finance, prior to submission to parliament. The existence of microfinance law will have a significant effect on infrastructure and development of MFIs and give protection for depositors. Last but not least, microfinance law will provide level playing field between MFIs players: BPRs and saving and loan cooperatives.

CONCLUDING COMMENTS:

1. I am grateful for suggestions that have been made by Mr. Timberg and consider them as substantial inputs for developing microfinance in general and BPRs in particular. Most of the recommendations have been implemented and hopefully, those inputs could generate a synergy.
2. I hope, and sure all of us do, USAID still deliver assistance to develop microfinance in much more focus way, as complement to research and seminars, and cover wider areas as other institution do.

Thank you,

Jakarta, June 16, 2003