WHY THE BANK RAKYAT INDONESIA HAS THE WORLD'S LARGEST SUSTAINABLE MICROBANKING SYSTEM

And what commercial microfinance means for development

by
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TABLES

I. INTRODUCTION

Today we celebrate the twentieth anniversary of the turnaround of BRI's microbanking system—from a massive, failed subsidized rural credit program begun in 1970, to the largest commercial microbanking system in the world.[1]

A great many people contributed over the years to this extraordinary achievement: the Indonesian government's remarkable economics team, BRI itself – from its head office to its thousands of units at subdistrict level nationwide, scores of Indonesian researchers, and many others. But there are three people who must be mentioned for their very special roles in BRI's microbanking transformation.

Among his many other contributions to the Indonesian economy, Pak Ali Wardhana, then Finance Minister, later Coordinating Minister for the Economy, and currently economic advisor to the government, was largely responsible for BRI's conversion to commercial microfinance. He had for some years envisaged the broad potential benefits for Indonesia that such a system could provide. But he also saw the risks that had to be avoided and planned accordingly. Pak Ali arranged for BRI's new commercial microbanking system to start in 1984. And ever since, he has watched over its development – as Indonesia became the world model for large-scale commercial microfinance.

In 1983 Pak Kamardy Arief was appointed BRI's President-Director to lead the turnaround. Under Pak Kamardy's leadership, the thousands of BRI units and their supervising branches were formed into a commercial microbanking system that vastly increased BRI's outreach to low- and lower-middle-income people throughout the country.

The late Pak Sugianto was BRI's Managing Director responsible for microbanking from 1984, when the new system began, until his untimely passing away in 1998. Pak Sugianto knew every one of BRI's 3,600 units at that time, and he worked indefatigably to turn each one around. He once said to me, "You can succeed in microfinance only if you love it." He did both. And the results are evident throughout Indonesia.

And their successors have continued the high quality commercial microfinance system that BRI built in the 1980s. They fostered its growth and guided it well through the East Asia crisis years of the late 1990s. And most recently, under the leadership of BRI's current President-Director, Pak Rudjito, BRI prepared for its very successful Initial Public Offering in November 2003. By December 2003—less than two months later—40 percent of this state-owned bank, 107 years old at the time, was held by private investors.

Back in the early 1980s, many at BRI said the government should allow BRI to close the unit system – because, as they said "the units are getting in the way of our real banking!" Now private investors, both domestic and foreign, are clamoring for BRI shares. Why? Very largely because of the bank's 20-year history of commercial microbanking. This is

[1] Parts of this paper are adapted from Robinson 2001, 2002.

an amazing story! What we celebrate today are the results of the first turnaround and the continuing leadership that makes possible important new breakthroughs in BRI's microbanking.

Seven topics are discussed in this paper.

- What is commercial microfinance?
- What went wrong at BRI's units from 1970 to1983?
- How did BRI's commercial microbanking transformation occur?
- Microbanking at BRI, 1984-2004
- The emerging global microfinance industry
- Microbanking challenges for Indonesia and BRI
- Doing good by doing well: the double bottom line
    - — The only way to provide financial services to large numbers of poor people on a long-term sustainable basis is to operate as a profitable business. It is the doing well (on the business side) that enables the doing good (on the social side) on a large scale. Since 1984 BRI has always had a double bottom line—and a very successful one.

II. WHAT IS COMMERCIAL MICROFINANCE?

In the many countries where the commercial microfinance industry is developing, a few leading financial institutions serve, in aggregate, a substantial share of their country's microfinance market. These institutions, which provide financial services mainly to low- and lower-middle-income clients, are operated as profitable businesses, thus enabling their large scale and their long-term viability.

Microcredit, in one form or another, has been practiced for millennia. But many of the principles, practices, and products, as well as the organization and management that characterize today's regulated large-scale commercial microfinance intermediaries, have been developed only during the past 20 years or so. It is the ability of commercial microfinance institutions to go scale and to maintain and expand their wide outreach profitably over time that defines the microfinance revolution. And Indonesia has played a leading role in this revolution.

BRI was the first bank in the world to provide commercial financial services—savings and loans, as well as other products—to millions of economically active poor and lower-middle-income households, and to do so profitably. BRI's microbanking system, which has been profitable every year since 1986, is now an integral part of Indonesia's financial system. This fact has far-reaching implications for the future of commercial microfinance globally, and for social and economic development generally.

Assuming a reasonably enabling macroeconomic and political environment, financial institutions using a commercial approach to microbanking can achieve the profitability that enables large-scale outreach to many people at the "bottom of the pyramid."[2] While more advanced in some countries than in others, the commercial microfinance industry is now emerging in all major regions of the world.

III. WHAT WENT WRONG AT BRI'S UNITS FROM 1970 TO 1983?

The units were established, beginning in 1970, as part of the government's BIMAS program for rice intensification.[3] The main role of the units was to channel subsidized credit to rice farmers (later they also provided government-subsidized loans to finance other agricultural activities as well). In a nutshell, the massive rice intensification program succeeded; its credit component failed. What went wrong at the units? The answer is that a lot went wrong.

- Loan terms and ceilings were set by the government.
- Government regulations stipulated that borrowers pay a subsidized 12% interest on credit, while the units were required to pay 15% on savings. This is an approach that comes with a guarantee of failure!
- Borrowers were selected largely by government committees.
- But BRI was responsible for loan collection—a bad combination!
- In practice, the below-market loans went mainly to rural elites, and in the process, encouraged corruption and politicization.
- Units were treated as branch windows, and the performance of the units was aggregated with that of their supervising branch. Thus the performance records of individual units were not reported separately, and little was known about them.
- Unit staff were poorly trained, unmotivated, and not well supervised.
- Unit managers had limited authority and little accountability.
- There were exceptions, but unit staff generally had poor knowledge of – and very little interest in – the microfinance market.
- The units were highly inefficient.
- They had minuscule savings. This was hardly surprising as every deposit meant a loss for BRI!
- The units had high loan defaults.
- The system had large and continuing losses.
- There were 3,600 units—0 were profitable.

It was, therefore, not surprising that by the late 1970s and early 1980s, many at BRI wanted to close the unit system. But the Ministry of Finance, representing the government as BRI's owner, had other ideas.

[2] See Prahalad 2005 for discussion of the vast potential at "the bottom of the pyramid' for eradicating poverty through profits.

[3] BIMAS is an acronym for Bimbingan Masal (Mass Guidance), the government's subsidized agricultural program operated through BRI, 1970-85.

IV. HOW DID BRI'S COMMERCIAL MICROBANKING TRANSFORMATION OCCUR?

There were four main ingredients: vision and leadership, policies, politics, and a new BRI culture for microbanking.

1. Vision and leadership

A number of factors in Indonesia's history came together here. First, at the time of BRI's transformation to commercial microbanking in 1984, the country had had good, consistent economic management and political stability for nearly 20 years. The government's long-serving economics team provided continuing high-quality leadership, characterized by a finely-honed combination of vision and caution. One result was that government investment of a substantial portion of the nation's oil wealth in rural areas during the 1970s led to increased rural demand for banking services by the 1980s.

In addition, by the 1980s, the economics team had begun to focus on the contributions to employment and the economy made by microentrepreneurs, and to recognize the vast unmet demand for financial services among this group.

A compelling point was that, in the early1980s, the government correctly anticipated a forthcoming decline in oil prices. Therefore, one aspect of the economic planning at that time was that the private sector would have to become responsible for a larger share of savings and investment.

It was in this general context that a bold strategy for commercial microbanking was developed in 1983. The vision on which it was based included a number of components. Some of the most important were these:

- BRI's units constituted a nationwide infrastructure that could potentially provide commercial microbanking to millions of savers and borrowers.
- The 3,600 units could be transformed into a commercial microbanking system, if it had appropriate regulations and experienced, skilled, and committed management.
- A growing commercial loan portfolio at the units would be funded by public savings.
- The profits would build the long-term viability of BRI's microbanking system.

This approach arose out of a broad view of the economy and society—especially important because no successful example of large-scale commercial microbanking existed anywhere in the world!

The new unit system began in early 1984—and the vision became a nationwide reality by 1986. By that year commercial microbanking (primarily loans and savings services) was offered at all units throughout Indonesia, outreach had greatly increased, and the system was profitable—as it has been every year since.

How did this vision become reality? The short answer is policies, politics, and a complete transformation of the culture of BRI's units.

2. Policies

A number of relevant policies were introduced, but the most important was Indonesia's wide-ranging 1983 financial deregulation, which included a crucial provision allowing state banks to set their own interest rates on most loans and deposits.

Other government decisions that affected the turnaround included:

- BRI units would receive government funding for two years, but no longer.
- BRI was informed that the units would either succeed commercially by then or be closed.

Another key reform was that the units were given a fresh start. Each unit was provided $19,000 in equity, and its liabilities were transferred to the unit's supervising branch.

3. Politics

In addition to policies there were, of course, politics. Only commercial credit (a new loan product called KUPEDES) was to be available at the units.[4] But the units' government–subsidized credit programs would be continued on a much smaller scale at BRI's branch offices.

As in many countries, credit subsidies tend to reach rural elites—whom governments often rely upon to deliver rural votes. Thus rural credit subsidies are notoriously difficult to end. The solution at BRI was not to stop the credit subsidies. Rather it was to take the subsidies out of the units, to decrease the subsidy amounts and move them to BRI's branches—and to let market forces operate at the units.

And that is exactly what happened. The units' commercial KUPEDES loans soon dominated the market.

4. Changing BRI's Culture

This started with crucial changes in governance and management—new oversight by the government as BRI's owner, and new BRI management.

I will never forget the day in mid-1983 when BRI's newly-appointed President-Director, Pak Kamardy Arief, called a meeting during his first week in office and announced that his first priority was to change BRI's culture. That shocked everyone! And very few people thought it would actually happen. But Pak Kamardy meant it. And BRI did it.

[4] KUPEDES is an acronym for Kredit Umum Pedesaan (General Rural Credit), the commercial loan product introduced to all units in 1984. With flexible maturities and repayment schedules, KUPEDES is available for all productive purposes. In 1989 when BRI began opening urban units, KUPEDES was expanded to include urban credit. It remains the units' single loan product.

The new culture was to include:

- Professionalism and responsibility
- Change of attitude toward a business focus
- Focus on training and on staff incentives based on the profitability of the particular unit in which they work
- Basic reform of internal supervision
- A high priority on transparency & accountability
- Knowledge of the microfinance market

In addition, the units would now become part of the "BRI family." Thus the salary scales of unit staff would no longer be far below those of the rest of the bank. And unit staff would no longer be ineligible for promotion to BRI's other departments or excluded from BRI's corporate functions.

Of course, it is one thing to announce a culture change. It is quite something else to implement it—but they did. There were two crucial initial changes. First, each unit was now treated as a profit center, with its own monthly balance sheet and profit and loss statement. Second, basic changes were made in accounting, reporting, and audit systems—which, for the first time, enabled accurate, regular measurement of each unit's performance, timely reporting, and transparent internal audit. Other aspects of the culture change included these:

- As planned, unit salaries and promotion criteria were now included as part of the wider BRI system, and unit staff were in fact quickly drawn into the "BRI family." These reforms made an important and immediate difference—in part because the contrast with the old system was so great!
- Training for unit management, staff, and supervisors was changed incrementally at first—by necessity, given the scale of the units' operations. But within a few years, training had been completely overhauled to reflect the units' new focus on business, financial skills, and market knowledge.
- Attractive performance-based incentives for unit staff (in the form of cash and institutional recognition) were quickly introduced—with great success.
- A bank-wide reorganization affecting microbanking management and supervision took place over time, extending from the head office to the regional, branch, and unit offices (see Robinson 2002, chapter 14).
- Increased staff authority, reallocation of unit staff responsibilities, a new internal supervision system, a new internal audit system—and a strong emphasis on skills and accountability— were key components of the transformation of the units.
- Women were recruited as unit staff for first time.
- Urban units were added in 1989.
- Extensive research was carried out on demand for savings and loan products. For the first time at BRI, low-income people were asked what kinds of financial products they preferred—a major milestone in Indonesian commercial microfinance.

- One general purpose loan product and three basic savings products were designed in ways that allow clients to customize product use for their own needs. The unit approach to clients became known as "standardization with flexibility."
- Also for the first time, the units' interest rate spread enabled the profitability of BRI's microbanking system.

Not surprisingly, however, many mistakes were made during the transition. But the committed and effective head office leadership was willing not only to identify and correct its mistakes, but also to learn from them. And the constant travel of the President-Director, Managing Director, and other head office managers to units and their supervising branches throughout the country generally resulted in quick learning about mistakes and fast turnaround on problem issues.

In addition to the crucial role of management, BRI's culture change at the units can be encapsulated in a three-point package: staff were given substantial responsibility; they were well trained in how to do their jobs professionally; and they were provided incentives which served to motivated them to make their units attain the outreach, transparency, and profitably that were expected. This approach was not a set of options. It was a package deal—all the components had to be implemented simultaneously. The result was a new corps of committed professional managers and staff—which can be seen today in BRI's offices around the country.

V. MICROBANKING AT BRI, 1984-2004

An overview of BRI's microbanking performance at its units from 1984-2004 is first provided. This is followed by discussion of the severe financial, economic, and political crisis in Indonesia in the late 1990s and the units' remarkable record of continued wide outreach and profitability throughout the crisis—even as the country's financial system collapsed. And then in 2003, galvanized by the extraordinary successes of its microbanking system, BRI shares were offered to the public for the first time. At the initial public offering (IPO), BRI shares were oversubscribed by nearly 16 times. Forty percent of the bank's shares are now privately owned. The reasons for the units' resilience during the crisis and for the attraction of investors to BRI's microbanking system are analyzed.

Unit performance, 1984-2004

The new commercial KUPEDES loan product replaced the old subsidized BIMAS loans at the beginning of 1984. KUPEDES loans were available from $25 to $1000 to all creditworthy borrowers for all productive purposes. A flat interest rate of 1.5 percent on the original loan balance was set to cover the relatively high overhead costs of the units (including depreciation) and the commercial cost of funds; it also covers estimated inflation and risk and it enabled profitability. Over time the maximum KUPEDES loan size increased, as long-time clients prospered and qualified for larger loans. As of 2004 the maximum KUPEDES loan is $5,400 (though few take loans at or near this amount).

Table 1 shows the number of KUPEDES loans from their introduction in 1984 to 2004, as well as KUPEDES long-term loss ratios during this period.[5] Table 2 shows the value of KUPEDES loans for the same years. The numbers of unit savings accounts and the value of unit savings are provided in tables 3 and 4 (see Robinson 2002 for more details and yearly performance figures).

These tables show a continuing rise in the number of KUPEDES loans over the 20-year period and a continued increase in the rupiah value of the outstanding loans. But in mid-1997 the East Asian financial crisis began, and Indonesia was the worst hit of any country involved. The World Bank commented in 1998, "Within the space of one year Indonesia has seen its currency fall in value by 80 percent, inflation soar to over 50 percent, the economy swing from rapid growth to even more rapid contraction, unemployment climb rapidly, and the stock exchange lose much of its value. Foreign creditors have withdrawn, investors have retreated. Capital and entrepreneurs have fled" (World Bank 1998, p. 1).

Table 1
Number of Outstanding KUPEDES Loans, 1984-2004

Year	Number of loans (thousands)	Long-term loss ratio (percent)
1984	641	1.0
1990	1,893	2.6
1995	2,264	2.3
2000	2,716	1.9
2004	3,211	1.6

Source: BRI unit monthly reports

Table 2
Value of Outstanding KUPEDES Loans, 1984-2004

Year	Billion rupiah	Million $US
1984	111	103
1990	1,382	727
1995	3,191	1,383
2000	7,827	816
2004	19,189	2,059

Source: BRI unit monthly reports

[5] The long-tern loss ratio measures the cumulative amount that has come due and not been paid since the unit opened relative to the total amount that has come due.

The crisis led to the resignation of President Soeharto in May 1998 —after 32 years in office. But even as the banking system melted down, BRI's microbanking system continued to grow, its loan arrears remained low, and the system remained profitable throughout.

Thus table 2 shows that between 1995 and 2000, the value of outstanding KUPEDES loans increased by 145 percent in rupiah terms, though it fell by 41 percent in dollar terms. And as indicated in table1, the long-term loss ratio for KUPEDES loans stayed at 2 percent or below throughout the crisis years and after. During the 21-year period from 1984-2004, 35 million KUPEDES loans were disbursed.

Between June 1997, the month before the crisis began, and the end of 2000, the number of loans increased, but slowly—from 2.5 million to 2.7 million in 2000. As the recovery from the crisis progressed, the number of outstanding loans increased somewhat more rapidly, from 2.7 million at the end of 2000 to 3.2 million at the end of 2004. And during these years the rupiah and the dollar value of outstanding KUPEDES loans jumped from Rp7.8 trillion ($US 816 million) to Rp19.2 trillion ($US 2.1 billion).

A similar, but more dramatic, picture is presented in tables 3 and 4, which show respectively the number of unit savings accounts and their value. The accounts were few and their value small in 1984, but by 1990 the units had Rp1.7 trillion (US$ 892 million) in 7.3 million accounts.[6] And savings continued to grow rapidly thereafter. By 1995 unit savings had reached Rp.6 trillion ($US 2.6 billion) in 14 million accounts.

Table 3
Number of Unit Savings Accounts, 1984-2004

Year	Number of savings accounts (thousands)
1984	—
1990	7,262
1995	14,483
2000	25,823
2004	31,272

—Not available.
Source: BRI unit monthly reports

[6] While KUPEDES loans were offered in the units in 1984, the new approach to demand-driven savings began more slowly. During 1984, most of the savings work was concentrated on demand research and product design, costing and pricing. The first pilot project in savings began in Sukabumi District, West Java, in November 1984. By the end of December that year BRI's Sukabumi units had more than doubled the total savings they had held two months earlier – which had been collected over more than a decade. Twelve additional pilots were conducted in 1985, and the savings program was then gradually rolled out. The new savings products were available in all units by late 1986 (see Robinson 2002, chapter 13).

Table 4 Value of Unit Savings Accounts, 1984-2004		
Year	**Billion rupiah**	**Million $US**
1984	42	39
1990	1,695	892
1995	6,016	2,606
2000	19,115	1,992
2004	32,882	3,528

Source: BRI unit monthly reports

Between 1995 and 2000, the number of savings accounts increased from 14 million to nearly 26 million. During the same period, the value of unit savings increased by 218 percent in rupiah terms—but because of the fall of the rupiah during the crisis, the dollar value of the units' savings fell by 24 percent.

The recovery from the crisis continued, and the units reached 32.9 trillion rupiah ($US 3.5 billion) in 33 million savings accounts in 2004, representing growth of 77 percent in dollar value since 2000, and of 21 percent in the number of accounts.[7]

Some recent trends, 2000-2004

- In the four years between December 2000 and December 2004, the number of savings accounts at the units increased by one million a year on average.
- The value of outstanding KUPEDES loans increased, on average, by about 20 percent a year.
- The number of units increased by 325 to 4,046, and the 5-year plan for the units includes growth of 100 new units a year.
- Of the 4,046 units in 2004, 96 percent were profitable (and most of the others were new units).
- An online real time centralized banking network was developed and is being introduced at the units; 450 units were on line real time in 2004.
- BRI's International Visitors Program, which has hosted about 1,850 visitors to the units from over 50 countries in the last decade, continues to receive large numbers of visitors who come to BRI to learn from its microbanking experience.

BRI goes public

As noted BRI began trading on the stock exchange in November 2003, with its long record of profitable commercial microbanking nationwide as the main attraction for investors. At the initial public offering (IPO), the strike price was Rp 875 per share. Shares were oversubscribed by nearly 16 times. At the end of the following month, 31

[7] The data refer to numbers of unit loans and savings accounts, which BRI tracks and reports. However, some savers have more than one account. The number of unit clients is not tracked.

December 2003, the public owned 40.5 percent of BRI shares. *Asia Money* named BRI "The best newly listed company in 2003."

By December 2004, the share price had reached nearly three times the strike price. Since the start of the crisis, Indonesia has had difficulty attracting foreign investors (to a significant extent because of continuing problems in its legal and judicial systems). But BRI is a striking exception. At present, the majority of its private investors are foreign.

Two frequently asked questions about BRI's microbanking system

When learning about the dramatic successes of BRI's units, many visitors ask the same two questions, which are very good ones.

Why did the units perform so well during the crisis?
Most microfinance clients operate in the domestic economy and were not directly affected by the fall of the rupiah (although many were indirectly affected). This fact, combined with the government's macroeconomic stabilization measures and emergency antipoverty programs, carried out with the assistance of international donors, meant that most economically active poor people stayed economically active – and were able to make use of commercial microfinance services.

Other reasons for the remarkable performance of BRI's microbanking system, even as the country's financial system collapsed around it included:

- Clients trust financial institutions that are trustworthy. At the start of the crisis in 1997, BRI had nearly 15 years of commercial microbanking experience. Its microbanking system had committed and experienced management and a very large group of well-trained, motivated staff. Most were able to use their skills and their knowledge of the microfinance market in an increasingly difficult context—and thereby to retain clients' trust.
- Unit staff and their supervisors, whose salaries and incentive payments are high by local standards, were strongly motivated to ensure that their units performed well—and that they continued in their jobs.
- In January 1998, the government guaranteed savings and deposits in all banks.
- But many savers in failing banks lost trust in their banks and moved their savings accounts to their local BRI units.
- Because of their large and stable savings, the units had substantial liquidity (most small account-holders do not move their funds offshore during times of crisis).
- Most unit borrowers entered the crisis with good credit ratings. For them, maintaining the option to borrow in time of crisis became a high priority. Borrowers understood that BRI's microbanking system was liquid and therefore if they repaid their loans promptly, they could obtain credit at any time. Thus unit clients knew that future borrowing from BRI was up to them.

- Over the years, many unit savers had built up substantial balances in their savings accounts that helped cushion the effects of the crisis (such as rising inflation and growing unemployment and underemployment, especially in late 1997 and 1998). When income was low, many borrowers were able to make loan payments from savings.
- High interest rates on fixed deposits could partially offset savers' income decline.
- Many of the units' clients were long-time customers at the time of the crisis. Valuing the security, convenience, and services offered by the units, most remained loyal customers both during and after the crisis.

BRI's microbanking system was the largest of the country's commercial microfinance institutions to ride out the Indonesian crisis successfully and profitably. But BRI was not alone in this achievement. In sharp contrast to the standard banking sector, other commercial microbanking institutions that had good management and a substantial savings base were also little affected by the crisis (see Steinwand 2001; Robinson 2002).

Why do BRI's units consistently have more savings accounts than loans, and a higher value of savings than of outstanding credit?

There are four main reasons that are typically found not only at BRI, but also at well-established commercial microbanking intermediaries generally. These are discussed below. But a fifth reason in the case of BRI is that the units can, and should, expand their lending. As discussed later, lending has increased at the units in the last few years, but there is considerably more scope for its expansion—both in established units and in the new units currently being opened. Much unmet demand for commercial loans among low- and lower-middle-income people still exists. The units operate in every subdistrict in the country, and the microbanking system has excess liquidity. BRI's microbanking system needs to gear up for expansion, especially on the lending side.

Yet even if considerable expansion in the number of unit loans occurs, as it should, unit savings accounts can still be expected to outnumber loans by a substantial margin and generally to have a higher value than the outstanding loans. The primary reasons are:

1. *BRI (and large-scale financial intermediaries serving the microfinance market in other parts of the world) have found that what most microbanking clients want is: one or more savings accounts in operation at all times, and the option to borrow at any time.* If the products and services provided are appropriate for their needs, most savings clients want to keep their savings accounts indefinitely. But contrary to the view of some microcredit advocates, not all poor people want to borrow all the time. What low- and lower-middle income microbanking clients typically want is not a continuous series of loans, but rather the *option* to borrow when they want. But there is high demand for voluntary savings accounts to which clients have continued access.

2. *Savers can have multiple accounts.* Microbanking clients of commercial financial intermediaries sometimes hold multiple savings accounts, typically used for different

purposes (as at BRI). And households often have savings accounts in the names of different households members. However, borrowers in such institutions are often permitted only one loan at a time.

3. *AT BRI's units, loans and savings accounts are structured differently, and in ways that lead to more savings accounts than loans.* Thus at BRI, borrowers receive credit in the form of one general purpose KUPEDES loan available in different amounts, and with a variety of payment schedules and loan maturities. These loans are often used by borrowers for more than one purpose. But savers achieve a similar result by customizing their use of several different savings products to meet their particular needs, thereby generating a larger number of savings accounts at the units than outstanding loans.

4. *While BRI places a cap on the amount of KUPEDES loans, there is no cap placed on unit savings accounts, and the value of savings is higher than the value of loans.* Profitable commercial institutions that fund their microcredit portfolios substantially or entirely from savings, as BRI does, cannot confine their savings services to poor savers. For the savings products in demand, the transaction costs are too high to collect savings only in very large numbers of small accounts. Therefore, when microbanking intermediaries mobilize voluntary savings from large numbers of low- and lower-middle-income people, they raise the average account size with larger accounts. Such institutions can then mobilize savings profitably and on a large scale, and they can afford to meet demand from low-income savers with small accounts. This approach permits the microfinance intermediary to meet local demand for savings services, to collect small savings from the poor, to use savings from all sources to finance an expanding microloan portfolio, and to maintain the institution's financial self-sufficiency. It also often provides excess liquidity. In BRI's case, this is used mainly for retail loans at their branches—most of which are based in rural areas.

VI. THE EMERGING GLOBAL COMMERCIAL MICROFINANCE INDUSTRY

Commercial microfinance today is an industry that is emerging globally—with the same general characteristics as are found in other kinds of developing industries. For microbanking, these include:

- Public regulation and supervision of commercial financial intermediaries
- Access by commercial microfinance institutions to commercial debt
- Market domination by a few industry leaders in most major regions of the world
- Growing competition among industry leaders (which is currently emerging at different rates in different countries)
- Rapid growth of microfinance rating agencies and their use
- Development of global industry standards for commercial microfinance

- The start of commercial investment in microfinance (a direct result of all of the above)
  —Most investment in the industry thus far has been from social investors in various forms: equity capital from the public sector, specialized equity funds for microfinance, and investments in particular institutions by a few socially-minded private investors. But private commercial investment is beginning, and as Michael Chu's paper in this volume points out, "The highly successful IPO of BRI shares in 2003 is a milestone...for the entire industry."

Industry leaders—which are of various institutional types— operate in many different social, economic, political, geographic, and demographic environments. Yet these institutions share the same basic characteristics:

- Clearcut, responsible ownership; knowledgeable and effective governance; and experienced, financially skilled management
- A competitive business approach with emphasis on asset quality, financial self-sufficiency, knowledge of the microfinance market, appropriate use of technology, efficiency, economies of scale, and attaining (and maintaining) substantial market share
- Use of commercial funding sources, such as public savings, commercial debt, and investment
- A corporate culture of transparency and accountability
- A broad infrastructure
- Strong emphasis on training for management and staff and on performance-based incentives
- A substantial market share

Not all industry leaders have all of these characteristics yet, but most have most of them. BRI has them all. But because of its early and massive lead over other microfinance providers, BRI does not yet operate in a highly competitive microfinance environment.

Commercial Microfinance in Asia

How do leaders of the emerging microfinance industry fare in the Asian context? Table 5 shows average data for the 22 participating Asian microfinance institutions (MFIs) in the 2003 issue of *The MicroBanking Bulletin* (MBB). The MBB is widely viewed as the industry's best source of global commercial microfinance data. Its participating institutions are either fully financially sustainable on a commercial basis or strongly dedicated to becoming so.

The table also shows the performance means for MBB's peer group of four large Asian institutions, defined by the MBB as institutions with portfolios over $8 million. The four large MFIs in MBB's large Asian peer group are BRI (by far the largest); Association for Social Development (ASA) in Bangladesh and Cambodia's ACLEDA Bank (both of which have been frequent visitor to BRI's International Visitors' Program); and First Community Cooperative (FICCO) in the Philippines. BRI is a commercial bank, ACLEDA is a specialized bank that was transformed from an NGO, ASA is a nongovernmental organization (NGO), and FICCO, which began its microfinance activities in 1999, is a credit union that was founded in 1954.

Average performance data for the four large institutions and for the eighteen other institutions are shown in table 5—which provides compelling evidence for the development of the Asian microfinance industry.

Table 5

MICROFINANCE IN ASIA
Adjusted Averages, 22 MBB Asian Participants

Indicator (2002 data)	Large MFIs N=4 (18% of Asian MFIs in database)	Other Asian MFIs N=18 (82%)	Performance: large MFIs as multiple of other MFIs
Number of loans (000)	1,282	28	46 X
Value of loans ($US million)	380	3	127 X
Number of voluntary savings accounts (000)	7,615	17	448 X
Value of voluntary savings accounts ($US million)	664	0.3	2,213 X

Source: *The MicroBanking Bulletin 2003 and unpublished data from the Microfinance Information Exchange (MIX).*

The first column of numbers shows average adjusted performance data for the MBB's peer group of four large Asian institutions (which represent 18 percent of the total number of participating Asian MFIs in the MBB database). Large for Asian MFIs is defined by the MBB as those with loan portfolios over $8 million. The next column shows average adjusted performance data for the 18 Asian MFIs with portfolios of $8 million or below that participated in the MBB in 2003.[8] Comparing the averages shown in these columns, the last column in the table shows that:

- The average number of loans of the four large institutions is 46 *times* the average for the total group.

[8] The MBB adjusts the performance data for each institution as needed for subsidies, standard loan loss provisioning, and inflation. To the extent possible with self-reported data, this approach enables standardization and makes possible comparability among institutions, which are treated as if all operated on a fully commercial basis.

- The mean value of loans for the four large institutions is 127 *times* the mean for the total group.
- For the number of voluntary savings accounts, the large MFIs have on average *448 times* the average for the total group.
- The mean value of savings for the four large institutions is *2,213 times* the mean for the total group.

This is a typical pattern for any emerging industry. Many small institutions start out, but over time a few institutions that have exceptional leadership, vision, skills and efficiency dominate the market, leaving others far behind.

> At the point when the accomplishments of the leaders make the promise of the field apparent, all kinds of players rush to enter. However, time quickly broadens the differences between the leaders and the rest as the latter are driven into irrelevance. It is instructive to remember that Ford once made airplanes and Kellogg manufactured telephones. I believe most MFIs today will leave even a fainter footprint in the history of development finance.
>
> —Michael Chu, 1998

Global Commercial Microfinance: Some Thoughts on the Future

Commercial microfinance is still an emerging industry in Asia, as elsewhere in the world. It is well developed in some countries, and at varying stages in others. But if we look to the future of the global microfinance industry during the next two decades, some crucial developments seem quite likely.

- For industry leaders, finance will not generally be a constraint. Loans will be financed from capital markets, public savings, investments, and other commercial sources.
- The major players will be large regulated financial institutions, especially banks (some transformed from NGOs), but also some large credit unions and credit union federations. Banks may be publicly or privately owned, or both. Some are likely to be owned by large retailers with extensive branch networks. In a few countries with very weak banking systems (as Bangladesh has been for decades), the dominant microfinance institutions may be NGOs or cooperatives.
- Commercial microfinance providers will operate in increasingly competitive environments, leading to improved efficiency and better client service (as is currently happening in parts of Latin America, especially Bolivia).
- There will be important roles for technology. And strategic alliances among types of institutions with different comparative advantages will continue to develop.
- Joint ventures will develop across national borders, and some large commercial financial institutions will provide microfinance in multiple countries. Some multinational banks will enter the market.
- Mergers and acquisitions will also occur, and many MFIs will either turn to other kinds of activities or close.

- Ownership of commercial microfinance intermediaries will become increasingly multinational (as has already happened at BRI).
- Large new markets, especially in India and China, will open to commercial microfinance.
- Commercial microfinance is changing rapidly, as are the markets and the skills required to provide microfinance services profitably on a large scale. To retain their leadership, industry leaders of today will need to change in some fundamental ways.
- The roles of donors and foundations are likely to turn mainly to various forms of industry development and to funding institutional capacity building, especially in new markets.
- The outreach of commercial microfinance globally seems likely to expand dramatically in the coming two decades (see Chu 2004).

VII MICROBANKING CHALLENGES FOR INDONESIA AND BRI

As in any industry, the leaders of today are not necessarily those of tomorrow. Many challenges lie ahead both for BRI's microbanking system, and for microfinance in Indonesia more broadly. Four quite different, but overlapping, kinds of challenges can serve to illustrate the wider picture.

1. BRI unit expansion

As BRI President-Director Rudjito said in his speech to the 2004 Microcredit Summit in New York, "We can serve millions more clients and micro- and small entrepreneurs." Despite BRI's remarkable growth in microbanking over the last two decades, there is still considerable room for expansion in its unit system. In a case study of BRI's unit banking system, Maurer and Seibel (2002) comment: "Given the potential of Indonesia's rural economy and the likely credit demand of micro and small businesses, the number of borrowers could probably double or triple."

And the Deputy Governor of Bank Indonesia, put it this way:

> Confirmation from many sources, including a BRI study, finds that despite the outreach of its own units, there is still an "unbanked majority" in all Indonesia's provinces...Despite all efforts at financial deepening over the past three decades, in Indonesia the majority of villagers still do not have access to financial services. And of course, this relates directly to poverty and unemployment.
>
> —Maulana Ibrahim, 2004

There is no doubt that the demand for financial services from low- and lower-middle-income people is far from saturated. But expanding microbanking services significantly, particularly on the lending side, represents a major challenge for BRI. Expansion of unit outreach and services with an eye to a competitive future involves initiatives of different kinds. Two examples illustrate the types of issues that are emerging.

Maintaining the double bottom line

As discussed, the only way to provide financial services to large numbers of poor people on a long-term sustainable basis is to operate as a profitable business—the double bottom line—both developmental and financial. But the double bottom line does not run on automatic pilot. It needs careful maintenance and periodic adjustments.

Recently the maximum KUPEDES loan was increased from 25 million rupiah ($2,700 at the end of 2004 to 50 million rupiah ($5,400). Unit managers and staff tend to welcome larger loan sizes (they generally consider it easier than providing many small loans). But if BRI's units are to expand their double bottom line, they need not only to provide larger loans, but also to reach out to many more new borrowers who need small commercial loans. The units' incentive structure should be carefully weighted to encourage both a larger loan portfolio and a significantly larger number of small loans—and, of course, the continuation of high repayment rates. Some retraining of managers and staff and special supervision may be needed, at least in the beginning.

The units and the branches

A related challenge is emerging as the unit system expands to include both greater numbers of clients and a considerable range in the amounts of their loans and savings accounts. In this context, the rationale behind the relationship of BRI's microbanking at the units and its retail banking at the branches needs rethinking. This is a relationship that needs to evolve. What clients should be should be served where? Developing the unit-branch relationship as a BRI strategic comparative advantage is currently a BRI priority. This is not an easy task, but it is essential for positioning BRI appropriately for the inevitable growth in microbanking competition during the coming decade.

Planning for the future

Among the challenges the units face is their need to guard against letting their two decades of success lead to complacency. And BRI must keep in mind that the quasi-monopoly position in microbanking it still holds in many areas will not last indefinitely—and in many parts of Indonesia, probably not through the next decade. To stay ahead in the industry, the units must act now as though they were today in a tough competitive market (which in some parts of the country they already are).

2. Developing competitive large-scale commercial microfinance in Indonesia

As noted, BRI holds a near-monopoly on commercial microfinance in many parts of Indonesia. But the country needs a more competitive market in large-scale commercial microfinance.

The issue is complex. A *Jakarta Post* editorial on microfinance (18 November 2004) pointed out that Indonesia has had a "wide mixture of successes and failures" in its microbanking efforts (BRI was cited as a major part of the success). This is a correct appraisal. There has been a mixed record historically, and there is a mixed record today. Many forms of microfinance are represented in Indonesia. Some are excellent. But many subsidized microcredit programs are characterized by various combinations of bad design, low outreach, poor performance, non-transparency, high defaults, politicization, and continuing losses. Some are imports from other countries or projects of foreign donors (or both). Others are home-grown cloning attempts.

As the home of large-scale commercial microfinance, Indonesia should not be importing from other countries non-sustainable methods of microcredit that do not work at home—and do not work in Indonesia either. Furthermore, large credit subsidies serve both to impede voluntary savings mobilization and to undermine the growth of competition in commercial microfinance in Indonesia.

What the country needs is more commercial competition for the business of providing financial services to low- and lower-middle- income people (as is now occurring in parts of Latin America). Some commercial banks are beginning to enter the Indonesian microbanking market— but slowly so far. Commercial intermediaries entering this market must compete against unregulated microcredit organizations with substantial subsidies, and in many cases with poor loan repayment records— a significant deterrent to new commercial entrants in the market.

However, there is little doubt that in the coming decade banks (perhaps including some multinational banks) will enter, learn, and compete in the Indonesian microbanking market. BRI is simply too profitable and too successful for this not to happen. But better informed and more effective uses of the funds that now subsidize microcredit could help speed the process.

Indonesia should encourage large-scale competition to BRI. In the long run, this will benefit not only the competing institutions, but also BRI—and most importantly the country's microfinance clients.

3. Ownership, governance, and management

One of the most important principles of the commercial microfinance industry is that owners, board members, and managers must be certified, using international standards, as "fit and proper"—and that they must be accountable for the obligations of their various positions. Thus owners of regulated financial institutions that serve microfinance clients are legally responsible for their institutions and for their decisions and actions. Board members must be competent to oversee a commercial financial intermediary in a rapidly changing environment, and must be committed to doing so. And managers must be well qualified—that is, experienced, financially skilled, hard-working, and knowledgeable about the microfinance market.

In Indonesia some microfinance institutions, especially the commercial ones, have a history of high-quality ownership, governance, and management. BRI's units, in particular, have a 20-year history of experienced, skilled, and innovative management – rare indeed for a state-owned bank! But Indonesia also has numerous microcredit institutions with managers who do not have the attitudes, financial skills, or managerial experience required for the kind of large-scale competitive microfinance the country needs.

And as commercial banks move into the microbanking market in Indonesia, their success will depend largely on the quality of management allocated to their microfinance efforts. This is, however, easier said than done. Thus far commercial banks (in Indonesia and elsewhere) tend not to appoint their best managers to lead their microfinance efforts, while managers appointed to a microbanking division tend to consider this a punishment posting!

In addition, commercial microfinance is still an emerging industry. Therefore experienced managers with strong financial skills, coupled with knowledge of the opportunities and risks of the microfinance market, are scarce—anywhere in the world. Well-qualified commercial microfinance managers are difficult to find and generally expensive. They need to be actively sought, and their services suitably budgeted. And careful oversight by a competent, well-structured board is essential.

Management is the largest bottleneck in the development of the commercial microfinance industry today. Management represents a major challenge for all microfinance institutions in Indonesia—including BRI as it moves in the coming decades into the future of a rapidly changing industry.

4. Increasing Indonesia's global leadership role in developing the commercial microfinance industry

Indonesia is a global leader in commercial microfinance. But except for microfinance experts, too few people know this (even in Indonesia!). The microbanking industry would benefit significantly if Indonesia in general, and BRI in particular, took a more active role in global industry leadership.

Internationally most people in business, government, banking, and economic development generally know little (or nothing) about microfinance. If they know anything, the response is nearly always, "Oh yes, microcredit. Bangladesh." Rarely have they heard of BRI or Indonesia in the context of microfinance.

And at the same time there has been continuing inaccurate, negative publicity about BRI and Indonesian microfinance—typically generated by those who want microcredit subsidies to keep flowing. For example, a recent paper, "Denial of Microcredit Services to the Poor in Indonesia", by the Chair of the Ganesha Foundation in Tangerang, Indonesia, was circulated among the global microfinance community. The paper states:

> The world-famous Grameen Bank, which serves above 2 million members in Bangladesh, [has]documented that poor households with continued access to its microcredit services were able to cross the poverty threshold in about 5 years…Yet the microfinance revolution has bypassed Indonesia, the fourth largest country in the world...Despite its claims, the state-owned Bank Rakyat Indonesia (BRI), which boasts a nationwide network of banks at the sub-district level, does not serve the poor and, perversely, continues to transfer substantial savings from rural areas and small towns to urban areas…BRI's countrywide network…stifles the growth of formal microfinance institutions, even though its credit services are directed to small towns and urban areas and not household enterprises in rural areas.
>
> —Shafiq Dhanani, 2004

The facts are, of course, quite different.

- Even after 20 years of growing gradually with their customers—which over time necessarily and appropriately raises the average loan size—the average outstanding KUPEDES loan balance in 2004 was $641 (76 percent of 2003 GNP per capita). And the average value of all types of unit savings and deposit accounts was $113 (14 percent of 2003 GNP per capita).
- Unit savings are not normally transferred from rural to urban areas. Most of BRI's branches serve rural areas, and excess unit savings are lent out in the larger loans provided at branch level. These retail loans help to develop local industries and to create employment in the rural areas, and are thus often of direct or indirect benefit (or both) to unit clients.
- It is also worth noting that the units supervised by the Jakarta regional office had $485 million in savings and deposits at the end of 2004, compared with $167 million in outstanding KUPEDES loans. Thus at the BRI units of the country's largest urban area, savings was nearly three times outstanding credit.
- The Grameen Bank has helped many poor people. But BRI has more than 10 times the number of Grameen's clients. And in sharp contrast to Grameen, which has received continuing subsidies for over 20 years, BRI's microbanking system has been profitable and financially self-sufficient for the past 18 years. And the units' 31 million savings and deposit accounts which average 14 percent of GNP per capita (and include all borrowers) would hardly suggest that BRI's units are "bypassing" the poor (see Maurer 2004).

Yet, when I am in India or Africa or Latin America, I find that aside from a few microfinance specialists, relatively few people know about BRI and the lessons on large-scale microbanking to be learned from Indonesia.

For many Indonesians, there is a powerful— and admirable—cultural norm that people should not talk publicly about the good things they have accomplished. But I think there are some Indonesian achievements that make speaking up internationally desirable—particularly those that can help poor people in other parts of the world. Of course there are, and have been for some time, some Indonesians who speak in the global arena about commercial microfinance. But more global leadership from Indonesia is badly needed in the commercial microfinance industry today (see Conroy 2004).

I was therefore delighted to hear of the reception accorded BRI President-Director Rudjito's speech at the 2004 Microcredit Summit. Many people, including world dignitaries, expressed great interest in his account of Indonesia's long experience in commercial microfinance and BRI's long record of providing large-scale microbanking services profitably to millions of clients.

This is what should be happening more and more. Millions of poor people around the world can benefit if Indonesia and BRI take a broader and more active leadership role in the global microfinance arena.

Indonesia and BRI

In summary, Indonesia has the oldest tradition of commercial microfinance among developing countries today, dating back to the late 19th century. BRI took an early lead in Indonesian large-scale commercial microbanking, and it has been the dominant player in the country for twenty years. Its microbanking system maintains at least one unit in all sub-districts of the world's fourth largest country. All loans have been financed by savings since 1989, repayment has been consistently high, and the microbanking system has been profitable every year since 1986—including the crisis years of the late 1990s when the country's financial system collapsed.

And BRI has made major progress with its recent partial privatization, while simultaneously focusing on expanding the number of its microbanking units.

Today BRI operates the largest profitable commercial microbanking system in history, and it is the first microfinance intermediary to offer shares broadly in the world's main financial markets. Together these two points—which are directly related—provide an important insight into the future of the global commercial microfinance industry.

And these are the units that many at BRI wanted to close in 1983!

But like all industry leaders in commercial microfinance (and those aspiring to leadership), BRI needs to prepare for its future role in microbanking. The markets, the risks, the players, as well as the skills and strategies needed to gain and maintain large market share, are rapidly becoming significantly different from those of twentieth-century microfinance. Even with BRI's dominant position today, it faces significant challenges ahead as commercial microfinance, like other industries, becomes globalized. And Indonesia confronts the challenging task of encouraging BRI's future microbanking activities, while simultaneously fostering development of large-scale, effective commercial microbanking competition in the country.

VIII. DOING GOOD BY DOING WELL: THE DOUBLE BOTTOM LINE

BRI's twenty-year history of commercial microbanking illustrates how microfinance does good by doing well. And in microbanking, doing well is essential for doing good on a large scale over time.

Doing Well

There is no question that BRI's microbanking has done very well (table 6). The unit system has been profitable every year since 1986—and its profitability continued straight through the crisis, although of course the dollar value of the profits declined sharply.

Table 6
BRI's Microbanking Profits, 1984-2003

Year	Profit or Loss (before tax)		Return on Assets
	Rp billion	US$ million	Percent
1984	- 25	- 23	—
1990	65	34	3.0
1995	403	174	6.5
2000	1,161	121	5.7
2004	2,168	233	6.2

—Not available
Source: BRI unit monthly reports

In 1996, the year before the crisis, the units' profit was Rp423 billion ($US 177 million). During the next two years—at the height of the crisis—their profit was Rp417 billion ($US 90 million) in 1997, and Rp714 billion ($US 89 million) in 1998. Return on assets was 5.7 percent in 1996, 4.7 in 1997, and 4.9 in 1998. Many banks in countries whose financial system had not collapsed would find these highly attractive returns. No wonder so many investors are interested in the units! With their $233 million profit and 6.2 percent Return on Assets in 2004, BRI's units are doing very well financially. But the world's largest commercial microbanking system is also doing good.

Doing Good: Who benefits?

What does doing good mean in microfinance?

- Microfinance benefits *clients*—including individuals, households, enterprises, organizations, and institutions. Commercial microfinance providers help their clients to borrow when needed, to store savings securely (as legally recognized assets)—and to obtain returns on these savings. These services help clients to expand and diversify their enterprises and to increase their productivity and incomes. And the clients' continued access to appropriate financial services helps them to improve the health of household members, to send their children to school and—most importantly—to gain self confidence.

- *Implementing financial institutions* can reach large scale profitably and, with good governance and management, can remain viable over the long term—as BRI and others have demonstrated.

- *Governments and donors* benefit because they do not need to provide credit subsidies or cover the losses of subsidized credit programs. And they benefit because their resulting savings can be used as needed for direct poverty alleviation for the extremely poor.

- *Economies* benefit from the increased production, from the new resources made available for investment, and from improvement in equity.

- *Societies* benefit from the gains in human capital—in education, health, skills, and dignity—and because large-scale sustainable microfinance helps to create an enabling environment for the growth of social and political participation, and of equity.

Commercial microfinance is a process, not an end in itself. By the end of this century (earlier in many places), I think microfinance institutions will have largely disappeared. Commercial finance for the "bottom of the pyramid" will have become part of the financial sector for the first time in history. And low-income clients who want financial services will get them at their local bank—as happens today at BRI.

When commercial microfinance becomes part of the world's financial system, it will have played an historic role in increasing the number of stakeholders in our global society. And Indonesia and BRI will have played a major role in this process.

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