LEGISLATION, REGULATION AND SUPERVISION

OF

MICROFINANCE INSTITUTIONS IN INDONESIA

Joint Paper by Bank Indonesia and GTZ

Project ProFI (Promotion of Small Financial Institutions)

January 2000

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List of Abbreviations

AVB	Algemeene Volkscredietbank (General popular credit bank)
BI	Bank Indonesia (Central Bank of Indonesia)
BKD	Badan Kredit Desa (Village Credit Board)
BKK	Badan Kredit Kecamatan (Sub-district Credit Board) in Central Java
BPD	Bank Pembangunan Daerah (Regional Development Bank)
BPR	Bank Perkreditan Rakyat (People's Credit Bank)
BRI	Bank Rakyat Indonesia
BU	Bank Umum (Commercial Bank)
CAR	Capital Adequacy Ratio
CRS	Catholic Relief Services
GTZ	Gesellschaft für Technische Zusammenarbeit (German Agency for Technical Assistance)
IDT	Inpres Desa Tertinggal (Presidential Instruction on Backward Villages)
KOSIPA	Koperasi Simpan Pinjam (Saving and Loan Cooperative)
KSM	Kelompok Swadaya Masyarakat (Self-help group)
KUD	Koperasi Unit Desa (Village Unit Cooperative)
LDKP	Lembaga Dana Kredit Pedesaan (Rural Fund and Credit Institution)
LPD	Lembaga Perkreditan Desa (Village Credit Institution) in Bali
MFI	Microfinance Institution
NGO	Non government organization
PHBK	Pengembangan Hubungan Bank dengan KSM (Linking Banks and Self-Help Groups)
PLPDK	Pusat Lembaga Perkreditan Desa Kecamatan (LPD Center)
ProFI	Pilot Project "Promotion of small financial institutions" by GTZ and BI
ROSCA	Rotating Saving and Credit Associations

SHG	Self-Help Group

1. Preface

"In terms of scale, variety, and volume of MFIs, market penetration, and profitability, the microfinancial services market in Indonesia is the most developed in the world." [Shari Berenbach in Craig Churchill, 1997: 5].

Presenting an overview on microfinance institutions (MFIs) in Indonesia from a regulator's point of view is indeed a challenging task. A reader unfamiliar with Indonesia's wealth in MFIs might be overwhelmed by all the acronyms, types and regional varieties of MFIs found here. This paper is an attempt to structure the MFI world in Indonesia and to analyze the present state of legislation, regulation and supervision. It is by far not comprehensive and figures presented below might not always be fully accurate, especially when we are concerned with MFIs in the semiformal and informal sector. Further research on this topic is underway and will be forthcoming soon.[1]

The unrivaled growth and variety of MFIs in Indonesia has evolved over the last 100 years. It is not a recent phenomenon as will be discussed below. Regulation and supervision have been important and highly debated issues since the very beginning of microfinance in Indonesia.

In defining microfinance, this paper adheres to the definition given in the recently published World Bank "Microfinance Handbook": "the term [microfinance] refers to the provision of financial services to low-income clients, including the self-employed. Financial services generally include savings and credit; … In addition to financial intermediation, many MFIs provide social intermediation services such as group formation, development of self-confidence, and training in financial literacy and management capabilities among members of a group. Thus the definition of microfinance often includes both financial intermediation and social intermediation. Microfinance is not simply banking, it is a development tool." [Ledgerwood, 1999:1]

Microfinance has long been acknowledged as a development tool in Indonesia. Bank Indonesia, the central bank, has been at the forefront in promoting and coordinating microfinance through various projects, initiatives and regulations. GTZ has provided valuable technical assistance to the field as a partner to the central bank. An exciting new pilot project was launched this year under the name of ProFI, which stands for Promotion and Capacity Building of Small Financial Institutions.

This paper has a special focus on BPR, because the BPR are directly regulated and supervised by Bank Indonesia and because they are hardly ever discussed in the literature about MF in Indonesia.

Finally, a note on the exchange rate of the Indonesian currency is required. Since the beginning of the Asian Crisis, the Rupiah has been severely battered and has been extremely volatile. The currency moved from a pre-crisis level of Rp. 2,200 to a peak of Rp. 16,000 to the US Dollar in January 1998. It has remained volatile since and only recently stabilized at a lower level around Rp. 7,000 to the US Dollar. However, this makes it difficult and meaningless to compare the Indonesian MFIs to MFIs in other countries using dollar terms. We have therefore refrained from indicating current US Dollar values for the period of the last two years.

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[1] ProFI, a joint project of Bank Indonesia and GTZ (German Technical Assistance) is preparing baseline surveys in three provinces and a comprehensive study on microfinance in Indonesia. Dirk Steinwand, GTZ, is about to publish on the subject within the framework of his PhD thesis. Data on LDKPs in this paper are partly drawn from his research.

2. Introduction

2.1. Indonesia in brief

Indonesia is a unity state that forms part of the world's largest archipelago with more than 13,000 islands extending over some 40 degrees of longitude along the equator, a span comparable to the continental United States. Located between Malaysia and the Philippines to the north and Australia to the south, the total area covered is 1.905 million square kilometers. It is home to some 200 million people of great ethnic and linguistic diversity. Population density is high in the so called Inner Islands of Java, Bali and Madura, which also form the economic centers of the country. The Outer Islands are less developed and population density is modest. The national language is Bahasa Indonesia. [Mc Guire, 1998: 143 – 145]

Before the crisis, GNP pro Capita income was slightly above US$ 1,000 and Indonesia was classified as a lower middle-income economy by the World Bank. It had achieved strong and continuous economic growth since the early 1970s and managed to diversify its economy. In the second half of 1997, Indonesia experienced a severe currency and banking crisis that led to political turmoil and finally to a democratic election of its fourth president, Mr. A. Wahid. The economy has reached its lowest point and seems to slowly pick up again. Inflation has come under control after jumping to 80% in 1998 and the Rupiah seems to be more stable now.

The crisis has caused substantial losses to the economy, especially to import dependent industries and has resulted in massive layoffs in urban areas. The price increases for agricultural products have somehow mitigated the negative effects of the crisis for landed farmers. Earnings form export crops got boosted when the Rupiah plunged towards the US currency.

There is consensus that poverty, however measured, has been on the decline in the past two decades until the crisis hit Indonesia. Still, the 1996 national household expenditure survey showed that despite remarkable achievements of the Suharto government, there were some 130 – 140 million people (70% of the population) that spent less than a dollar a day[2].

The informal sector of the economy was estimated to count some 50 million microenterpreneurs before the crisis and has been growing since due to an influx from laid off workers that are trying to gain a new self-employed income. The demand for microfinance is growing and microfinance itself is gaining importance for the resiliency of the national economy.

Nowadays, microfinance is all the more important since commercial lending has come to a virtual stop and is only slowly picking up again. For the last two years, microbanks were the only banks in Indonesia that continued to extend loans to customers.

2.2. Indonesia's banking system is facing the crisis

Bank Indonesia, the central bank, is both regulator and supervisor of all banks in Indonesia, until the year 2002, when supervision is mandated to be handed over to a new bank supervisory agency[3].

The banking act[4] recognizes two different bank types:

[2] The official poverty line for urban areas was set at Rp. 1,300 (corresponding to 56 cents at pre-crisis exchange rate) per capita per day and for rural areas at Rp. 900 (corresponding to 38 cents). According to this official definition of poverty, only 12% of the population fell under the poverty line. [Mc Guire, 1998: 143]

[3] The new central bank act No. 23, 1999 has revised the former act of 1968 and given Bank Indonesia a fully independent status.

[4] See banking act No. 7 of 1992 as revised by act No. 10, 1998.

1. Commercial banks (*Bank Umum,* BU) or primary banks have access to the central bank clearing system and are offering a full range of banking products. They include: 27 Regional Development Banks (*Bank Pembangunan Daerah*) owned by the provincial Governments, 3 state banks, 93 private national banks, 41 foreign and joint venture banks. The total number of commercial banks is 164 and the number of bank offices is 5,953. Their combined balance sheet is worth Rp. 708,004 billion. [5]

2. People's Credit Banks (*Bank Perkreditan Rakyat,* BPR) or secondary banks of an extremely small size compared to primary banks – minimum capital required to open a BPR was Rp 50 million until recently – and without access to the payment system, offer only a limited range of basic banking products (savings and deposit accounts, credit, no checking, no foreign exchange). The total number of BPRs is 2,420[6]. Their combined balance sheet is worth Rp. 3,220 billion, which corresponds to about 0.5% of commercial banks' assets. [7]

Indonesia's banking system is currently undergoing a massive restructuring program under the lead of IMF, World Bank and ADB. Financial aid amounting to US $ 43 billion has been pledged by donors to help reform the ailing banking sector and get the economy moving again. The banking sector is at the centerstage of reforms and is believed to be one of the main culprits for the crisis. To recapitalize the sector and raise CAR to a minimum of 4% is estimated to cost around US $ 80 billion corresponding to 71% of GDP.[8] Funds are raised partly through government bonds (80%) and through equity injection from bank owners (20%).

After closing the first batch of 16 banks in November 1997, the government had to extend a guarantee on all bank deposits and certain bank liabilities to prevent a nationwide bank run. The guarantee is still in place. So far, Bank Indonesia has closed as many as 38 private banks[9] and has put a total of 55 private banks under IBRA (Indonesian Bank Restructuring Agency) management[10]. Other private banks were merged to prevent government takeover. Four state banks were merged into Bank Mandiri, reducing the number of state banks from 7 to 3. IBRA is currently the most powerful and important economic vehicle in Indonesia, controlling banking assets worth Rp. 600,000 billion.

It is noteworthy, that the microfinance industry in Indonesia weathered the crisis much better than commercial banks, which could only survive with massive liquidity support, government guarantees and an expensive restructuring program. Some healthy MFI have actually gained from the crisis by attracting additional savings at relatively low rates and by maintaining the quality of their portfolio through improved customer selection.

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[5] Figures are per June 1999, adopted from "Indonesian Financial Statistics" published by Bank Indonesia, August 1999.
[6] Bank Indonesia official statistics (e.g., the monthly published "Indonesian Financial Statistics") referring to BPR also include 5,345 so called BKD in this category. BKD are a special type of BPR, which will be dealt with below. BKD are supervised by BRI on behalf of Bank Indonesia and are a credit-only MFI. For the sake of this paper, when we refer to BPR we exclude the BKD.
[7] Figures on asset as per June 1999, adopted from "Indonesian Financial Statistics", August 1999. Number of BPR according to information from the BI Directorate of BPR supervision in Jakarta.
[8] All banks had to undergo due diligence to assess their current CAR and were divided accordingly in three categories. Category A banks are all banks with CAR higher than 4%, category B are banks with CAR between –25% to 4% and category C are banks with CAR below – 25%. Only category B banks qualified for the government recapitalization program, if owners committed for at least 20% of recapitalization cost, managers had passed the fit and proper test and Bank Indonesia had agreed to a business plan. Bad debts were then taken out of the balance sheet and sold to newly created Indonesian Bank Restructuring Agency (IBRA).
[9] All depositors have been refunded under the government guarantee scheme.
[10] Of those 55 banks, the government has taken over 4 large private banks, has frozen the operation of 10 private banks and has recapitalized 9 private banks and 13 Regional Development Banks (BPD).

2.3. Microfinance in Indonesia

Historical Roots

Current microfinance textbooks suggest that microfinance arose in the 1980s as a response to widespread failure of donor and government driven, targeted credit programs. Those textbooks hail Professor Mohammed Yunus in Bangladesh with his Grameen Bank and BRI with its Unit Desa network as the pioneers of microfinance in Asia [cf. Ledgerwood, 1999:2]. However, the birth of microfinance in Indonesia dates back more than a hundred years. It started with the establishment of the "Priyayi Bank of Purwokerto" by Raden Wiriamaadya in 1895 and the "Poerwokertosche Hulp-Spaar en Landbouwcredietbank" established one year later by the Dutch administrator Sieburgh and his colleague De Wolff van Westerrode, both inspired by the German pioneer Raiffeisen. The early "Volkscredietwezen" (popular credit system) fostered the emergence of a variety of thousands of small village banks with millions of micro-borrowers. The movement finally culminated in the foundation of the "Algemeene Volkscredietbank" (AVB-Bank) in 1934, which later became Bank Rakjat Indonesia (BRI). It is worth noting that the founders of the "unit desa" pilot project for modern Bank Rakyat Indonesia consulted extensively the credit manuals of the AVB-Bank to design the now famous Kupedes loan and Simpedes savings products. [Schmit, 1994: (1)] The world's most famous microfinance success story, the BRI Unit Desa, is firmly rooted in 100 years of experience and experiments in this field. In Indonesia, microfinance is the modern term for what used to be the colonial "Volkscredietwezen".

It is also interesting to learn that right from the beginning of the history of popular credit banks in Indonesia, the main issues were of political and regulatory nature: should loans to the Indonesian people be extended through cooperative organizations or through banking institutes? How far should the state intervene to control and regulate the popular credit banks and how to protect the public from the "notorious Chinese moneylenders"? In 1904, the colonial Government established an inspector of popular credit banks with 24 supervisors to oversee a rapidly growing network of popular credit banks operating "lumbung padi" (literally rice barns; banks that allowed villagers to secure a rice advance until the following harvest) and village banks. Within 6 years, i.e., from 1906 to 1912, the number of popular credit banks rose from 33 to 75, from 7,424 to 12,424 lumbung padi and from 300 to 1,336 village banks. Concerns about how the Government could stay in control of this movement led to a centralization of the system and to granting of subsidized funds [Schmit, 1994: (4)]. Evidently, regulation and supervision, the hottest topic in modern microfinance, seems to have been as important a 100 years ago as it is today. [11]

Another historical parallel may be drawn in analyzing the impact of the Depression before the Second World War and the recent Financial and Monetary Crisis – "affectively" called KRISMON in Indonesia – on microfinance in Indonesia. During the Great Depression, popular credit banks drastically reduced their credit expansion and lost nearly two-thirds of their customers while being confronted with increasing levels of bad debt. Their losses had to be borne by the guarantee of the Central Fund. The village banks and lumbung padi, however, fared much better while they were able to remain relatively independent of the Central Fund. About 50% of the lumbung padi and 65% of the village banks were still able to generate profits in 1933, although their client base was reduced too. Similarly, KRISMON has most affected those banks that are linked to the payments system and located in the economic centers of the country, whereas the more remote and isolated BPR and LDKP managed much better to overcome the crisis. As in 1933 with the guarantee of the Central Fund, the unsound BPR of today will have to be bailed out by a government guarantee.

Present Landscape

To understand the context of microfinance in Indonesia, an overview of the whole financial system is presented. Table 1 below is dividing the supply side of the financial system into three sectors,

[11] The Article on "History, present situation and problems of the village credit system (1897 – 1932)" by Thomas Anthonij Fruin published in 1933, reads like a modern microfinance treaty on regulation and supervision of MFIs. [see Klaas Kuiper, 1999]

according to each institution's degree of formalization. The formal sector comprises financial institutions that are chartered by the government and are subject to regulation and supervision by the state as opposed to the informal sector, which comprises intermediaries that operate outside the framework of government regulation and supervision. Between the two sectors, there is a so called semiformal sector that comprises institutions that are not regulated by banking authorities but are registered and/or licensed by other state authorities or regional governments.

In most countries, microfinance is typically dominant in the semiformal and informal sector. This is not the case in Indonesia. The frontier of microfinance has been pushed into the formal sector and the formal sector has been regulated to accommodate MFIs. Many financial institutions in the formal sector provide microfinance services and have a long tradition of doing so (Bank Rakyat Indonesia and some village banks). The contribution to microfinance by the formal sector outperforms the semi- and informal sector in terms of outstanding loans and savings as well as in number of micro-borrowers and -depositors. This is a result of Indonesia's long tradition in microfinance that goes back to the early village banks described above.

Table 1: Overview of the supply side of Indonesia's financial system[12]

Formal sector	Semiformal sector	Informal sector

[12] Figures per June 1999. Figures marked with * are estimates.

Central Bank: Bank Indonesia **Banks:** - **170 Commercial Banks (Bank Umum, BU) with 5,997 bank offices and 3,703 BRI Unit Desa** - **2,420 Peoples' Credit Banks (Bank Perkreditan Rakyat, BPR)** - **5,345 Badan Kredit Desa (BKD)**	**400* NGO microcredit programs**	**250,000* Rotating savings and credit associations (ROSCA) and variants: Arisan**
Nonbank Financial Institutions: - **2,272 Rural Fund and Credit Institutions (Lembaga Dana dan Kredit Desa, LDKP)** - **633 state pawnshops (pegadaian)** - **Finance companies** - **Insurance companies**	**Numerous development projects by government agencies and international donors**	**Self-help groups:** - **6,000 Saving and credit groups (Kelompok Simpan Pinjam, KSP)** - **15,000 Microenter-preneurs groups (Kelompok Pengusaha Mikro, KPM)** - **30,000 KPK (P4K)** - **2,908 BMT**
Cooperatives: - **5,335 Village Unit Cooperatives with Saving and Credit (Koperasi Unit Desa dengan USP, KUD/USP)** - **1 Credit Union (Badan Kordinasi Koperasi Kredit (BK3I/BK3D)** - **1,160 Saving and Credit Cooperatives (Koperasi Simpan Pinjam, Kosipa)**		**Individual moneylenders (commercial and noncommercial)**
Contractual savings institutions: - **insurance companies** - **pension funds** **Markets: Jakarta and Surabaya stock exchange**		**Traders and shopkeepers**

Indonesia is far advanced when it comes to the size of its **formal microfinance sector**. The formal sector alone counts 3,703 BRI Unit Desa, 2,420 BPR, 5,345 BPR of the BKD type and 2,272 LDKPs combining a total of 13,740 microbanks that are serving almost 30 million clients all over the country. It is obvious that the sheer size of these figures presents a formidable challenge for the regulators and supervisors of microbanks. In addition, there are 636 state run pawnshops[13], which offer ready cash against valuables at competitive rates of interest to more than 10 million clients.[14] They are supervised by the Ministry of Finance. The cooperatives have so far played a minor role as financial intermediaries due to repressive regulation and excessive government interference under the New Order Regime of former president Suharto. However, the more than 5,335 government sponsored KUDs are established throughout the country and would in fact possess a tremendous microfinance potential if properly stimulated and regulated.

[13] The Dutch took control of the mainly Chinese owned pawnshops around the turn of the last century, which later passed to the Indonesian government and has remained a government monopoly since – private pawnshops are illegal. State pawnshops offer cash against valuables in times of emergency. In 1998, due to the financial crisis, the number of pawnshop customers increased by 93.7%. Pawn redemption is reported to be as high as 99.3%. [Bank Indonesia, Annual Report, 1998: 111 – 112; Cole and Slade, 1996:307 – 308]
[14] Bank Indonesia, Annual Report, 1998: 111 – 112.

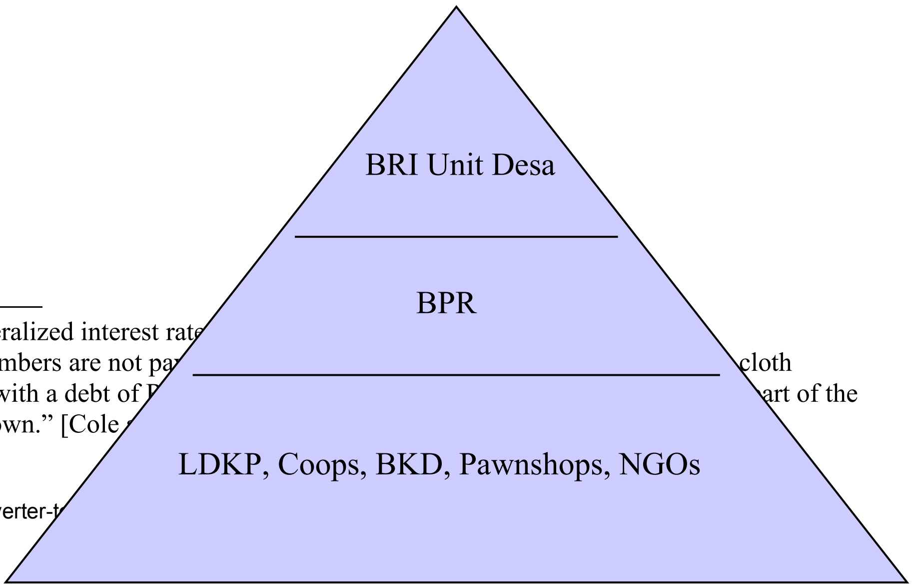
The **semiformal sector** is estimated to serve an additional 1 - 2 million clients, generally with a smaller repayment capacity than those clients served by the formal sector. They are at least 400 NGOs that have started credit programs to selected target groups, mostly using the self-help group approach. The more advanced NGOs like Bina Swadaya in Jakarta and YIS in Solo have managed to upgrade their programs into BPRs and have inspired other NGOs to follow a similar approach. All in all, however, the NGO contribution to microfinance in Indonesia remains rather small. Several ministries (Home Affairs, National Planning Board, National Family Planning Board, Agriculture, Transmigration) have fostered their own approach to poverty alleviation using microcredit without much coordination and based on different philosophies, often contradicting the microfinance policies promoted for the formal sector. The basic difference between Bank Indonesia's policy for microfinance[15] and the various state ministries always revolved around the question of subsidized interest rates for credit. Whereas Bank Indonesia started to abolish interest rate subsidized credit schemes after 1991, other government programs were proud to provide loans to target groups at rates even below the banks' interest rates for savings. This has led to some irritations, but has not undermined the development of microbanks. The largest government program using microcredit as a tool to eradicate poverty is the "backward village" program (Inpres Desa Tertinggal, IDT), which has established self-help groups in about 20,000 so called "backward" villages.

The **informal sector** counts a wide variety of arisan, the Indonesian name for indigenous ROSCAs (rotating saving and credit associations). They are spread all over the country, although more popular in the Inner Islands. In the absence of statistical figures, the number of arisan and people participating in these institutions can only be estimated very roughly. Assuming that every tenth Indonesian adult participates in an arisan would mean that about 5 Mio people are involved and assuming an average of 20 persons per arisan would result in approximately 250,000 rotating saving and credit associations.[16] A more developed form of informal financial institutions are the various types of self-help groups, which are usually summarized under the Indonesian term Kelompok Swadaya Masyarakat or simply KSM. According to the monitoring of the two largest national projects[17] working with self-help groups, there are more than 50,000 self-help groups that have reached bankability and have had at least one bank credit. Loans from friends, relatives, shopkeepers, traders and professional moneylenders – although illegal in Indonesia – are another very important source of rural finance, though difficult to quantify. Studies in the 80s and 90s suggest that informal finance remains very large and has an important impact. There are various informal credit patterns in different parts in Indonesia. Most popular are the ijon (forward selling of a crop), sewa and gadai (forms of land lease with fixed or indefinite period and with net proceeds of cultivation as repayment of principal and interest).

The various MFI cater for different customer groups. The BRI Unit Desa are serving part of the upper segment of the MFI customer pyramid, followed by BPR, cooperatives, LDKP, and so on. The lower the segment in the customer pyramid, the larger the size of its potential customer group and the lower its average credit repayment capacity.

Illustration 1: The MFI customer pyramid

As we move down the pyramid, costs of financial services tend to increase, as saving and credit repayment capacity of customers gets smaller. In fact,



[15] Bank Indonesia liberalized interest rat

[16] Arisan do fail if members are not pa cloth traders' arisan failed with a debt of R art of the market was burned down." [Cole

[17] PHBK and P4K

effective rates of interest in BRI are the lowest, followed by BPR and LDKPs. Cooperatives (KUDs) and NGOs are usually providing subsidized loans at below market rates. Based on available statistic data, it is not possible to indicate the degree of market penetration of the BRI, BPR and LDKP etc. This could only be done for individual provinces based on special surveys. ProFI is about to prepare such surveys for its pilot provinces in East Java, Bali and NTB.

Size of Microfinance in Indonesia

An attempt is made below to quantify the size of microfinance services in the formal, semi-formal and informal sector. The various MFIs and other institutions are listed according to the size of the average credit outstanding.

Table 2: Size of microfinancial services in Indonesia[18]

	Number of Units	Number of Savers & Borrowers	Total Credit Outstanding (in million Rp.)	Average Loan (in million Rp.)	Total Deposits/ Savings (in million Rp.)	Average Deposits/ Savings (in thousand Rp.)
BRI Unit Desa	**3,703**	**23,000,000**	**4,700,000**	**2,000**	**17,500,000**	**750**
BPR	**2,420**	**4,233,000**	**2,012,000**	**1,000**	**1,657,000**	**400**
Saving & Credit Coops (Kosipa)	**1,160**	**3,050,000**	**553,000**	**820**	**169,000**	**55**
LDKP**	**2,272**	**1,326,000**	**358,000**	**600**	**334,000**	**575**
- BKK	778	440,000	96,000	325	66,000	150
- LPD	910	545,000	170,000	860	182,000	1,000
BKD	**5,345**	**758,000**	**132,000**	**174**	**18,000**	**25**
KUDs (Village Unit Coops)	**5,335**	**3,050,000**	**356,000**	**115**	**46,000**	**15**
Pawnshops	**633**	**10,000,000**	**793,000**	**80**	**-**	**-**
NGOs*	**400**	**200,000**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
Self-help groups*	**100,000**	**1,000,000**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
Arisan*	**250,000**	**5,000,000**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
TOTAL***		**51,000,000**				

*Estimated **Estimates for all LDKP are based on LPD and BKK data, see also 6.1 and 6.2
*** Double counting is likely: members of self-help groups may participate in an arisan and may also have a savings account at BRI Unit Desa and a loan from a BPR.

Obviously, BRI dominates all other MFIs with 23 million customers, mainly savers. Pawnshops serve 10 million people with emergency loans of a very small size at the other end of the pyramid. The formal sector in the above table dominates clearly. The challenge is to expand outreach in the middle and lower segment of the pyramid, where people seek very small loans and are difficult to reach.

3. Legislation, Regulation and Supervision

3.1. The Rationale of Regulation and Supervision

Legislation and **regulation** of financial institutions refer to the legal framework and governing principles of financial intermediation in a country, by defining the roles of its banking authorities (central bank, ministry of finance, bank superintendency etc.), setting out rules for entry and exit of various types of financial institutions, determining and limiting their businesses and products and specifying criteria and standards for the sound and sustainable operation of the industry. Regulation is not limited to rules set by the state only, but may include forms of self-regulation by networks, associations, apex organizations etc. **Supervision** encompasses all means by which the regulators enforce compliance to a given legal and regulatory framework.

The principal **rationale** for regulating and supervising traditional financial institutions is **consumer protection**, primarily but not exclusively in the form of public depositors. Because the interests of the financial institution and the interests of the consumer are not congruent per se – leading to moral hazard – and because the individual depositor/investor is not in a position to judge the soundness of a financial institution – adverse information – nor to influence its management, an impartial third party is required to regulate and control the soundness of a country's financial institutions. This may be the state or another agency appointed by the state. Because bank failures tend to be contagious and affect other banks regardless of their soundness, the protection of the whole banking and payment system becomes an additional goal of regulation and supervision. However, regulation and supervision does not come for free. Its price has to be carefully adjusted to the benefit it produces. Over-regulation or financial repression may limit the efficiency of financial intermediation and increase costs for

[18] Data from BI Directorate for BPR supervision, Jakarta, per June 1999.

consumers. There is a trade-off between regulation and the stability of the financial markets on one side and the efficiency of the industry on the other side. Therefore, governments need to make sure that the regulators and supervisors have the capacity and right incentives to constantly monitor and if necessary adjust the delicate balance between market efficiency and market stability.

Regulating MFIs: why, how and by whom?
In principle, the above rationale should apply to all kinds of financial institutions, both formal banks as well as MFIs. As soon as there is a considerable risk that consumers might lose their money, regulation and supervision is warranted. In practice, however, this apparent clear cut is often difficult to make. Obviously, a large deposit taking MFI that is refinancing its operations mainly through public deposits beyond closed communities where common bonds exist, requires regulation and supervision [C. Churchill:1]. Should the bank superintendency supervise such a MFI? The experience in Bolivia with BancoSol and with Finansol in Columbia suggests that the traditional instruments of bank supervision (prudential ratios) fail to adequately monitor and control the specific risks of MFIs. Should MFIs therefore be regulated under a special MFI law or should the existing banking act be amended? What about a MFI that is only taking deposits from borrowers in the form of cash collateral, as it is widely practiced by semi- and informal MFIs in Indonesia? What about credit-only MFIs? Should they be regulated and if yes, how and by whom? How far can self-regulation be introduced?

Indonesia has answered these questions by choosing a multi-agency and tiered regulatory framework for MFIs and a so-called hybrid approach to MFI supervision. Size and type of deposit taking are the main criteria to regulate and supervise MFIs, as will be further explained below.

3.2. Legislation, Regulation and Supervision of MFI in Indonesia

In Indonesia, the legislator has regulated public deposit taking MFIs under the banking act by recognizing a new type of bank or microbank, rather than promulgating a special MFI law. Commercial banks with an MFI window, like the BRI with its Unit Desa network, are regulated under the same banking act and are considered part of a commercial bank. By law, all banks are supervised by the central bank until the year 2002, when a new bank superintendency shall be created and take over from Bank Indonesia. In practice, out of 13,740 microbanks Bank Indonesia is only directly supervising the 2,420 BPR non-BKD, and has concluded special arrangements with other institutions to supervise on BI's behalf. This approach has been referred to in the literature as the hybrid approach. [Shari Berenbach and Craig Churchill: 25; Stefan Staschen, 1999:3]

4. BRI Unit Desa

4.1. History

Bank Rakyat Indonesia (BRI) is one of three state banks. It houses the world's largest MF network, i.e., the BRI Unit Desa. The Unit Desa (village units) were established in the early 1970s as outlets under a government scheme (BIMAS) to provide agricultural inputs for the cultivation of high-yield hybrid rice. Whereas the green revolution was a success, lifting rice production to levels of self-sufficiency, the credit side of the extension program was a complete failure, marred with increasing arrears and losses. In 1983-1984 it was decided to discontinue BIMAS. This could as well have meant the end of more than 3,000 Unit Desa, which in many rural areas represented the only formal banking services available to the people. However, planners in the Ministry of Finance and the BRI decided to restructure the whole Unit Desa and turn it into a financially viable institution. With technical support from the World Bank, USAID and HIID, the planners built once more on the roots of BRI's predecessor, the AVB-Bank and its rich experience in rural credit. With the launching of two simple but well researched tailor-made products, the KUPEDES loan and the SIMPEDES savings account, the right mixture of staff incentives and by treating each unit as a profit center, the Unit Desa soon became profitable and expanded all over the country. [Patten and Rosengard, 1991: 2-3]

4.2. Profile[19]

There are currently 3,703 Unit Desa all over Indonesia located at sub-district level. "A Unit is a small bank office with four to eleven staff. The Units also maintain 375 cash posts, which are open, three to five days a week to receive and pay out savings and to receive loan repayments… The Units make loans of Rp. 25 thousand to Rp. 25 million. There were 2.4 million micro loans outstanding at the end of May, 1999. The Units also provide savings, giro and time deposits accounts; there were 23.2 million accounts in the Units a the end of May, 1999." [Patten, 1999:2]

All units offer two main products[20]: a savings passbook called SIMPEDES allowing for unlimited withdrawals and offering a competitive rate of interest and a flexible, collateral requiring installment type of credit called KUPEDES for working capital and investment purposes, carrying a flat rate of interest well above the SIMPEDES rate of interest. KUPEDES repayment has been excellent even through the crisis. "So far, KUPEDES borrowers have continued to pay back more than 97% of everything that has fallen due." [Patten, 1999:8]. The twelve months loss ratio was at 1.51% at the end of May 1999. Total outstanding loans were at Rp. 4.7 trillion with 2.4 million loan accounts. The current effective rate of interest is at 34.74%. [Patten, 1999: 5] SIMPEDES savings amounted to Rp.17.5 trillion in May 1999[21] with almost 15 million passbooks. The current rate of interest is 19%. LDR is around 25%, savers to borrowers ratio is 1 : 6.
The system is highly profitable, generating interest rate margins between 10 – 18% over the last 18 months. Unit Desa overliquidity is absorbed by the BRI branches.

4.3. Regulation and Supervision

Unit Desa is a division within Bank Rakyat Indonesia, a commercial state bank regulated under the banking act and supervised by Bank Indonesia. Within BRI, the Unit Division is responsible for overseeing the whole unit desa network, which operates independently of BRI's branch system. Supervision of the unit desa is undertaken by two managers of the Unit Division placed in each BRI branch and reporting directly to the branch manager. The Unit Desa manager is responsible for visiting each unit once a week (on-site supervision) to verify reports. The Unit Desa report daily (trial balance), weekly (liquidity report), monthly (progress report, balance sheet, income statement), quarterly (personnel report), semi-annually (past performance indicators for contest achievement) and annually (balance sheet and income statement) to the supervising branch, regional and head office.

The loan classification and reserve system shown in table 3 below is more stringent than Bank Indonesia's criteria for BPR.

Table 3: BRI Unit Desa Loan Classification and Reserves

Loan Classification	Delinquency	Loan Loss Reserves: 3% of total portfolio plus …
"before due"	Late payment	0%
Substandard	Up to 3 months	50%
Doubtful	3 – 9 months	100%
Bad-debt	9-12 months	100%
Write off	Above 12 months	100%

[19] Figures from R. H. Patten, "The East Asian Crisis and Micro Finance. The Experience of Bank Rakyat Indonesia through June 1999", Jakarta, July 1999.
[20] Besides the famous SIMPEDES savings account, BRI Units also offer time deposits, SIMASKOT and TABANAS passbook savings.
[21] "Since the beginning of the monetary crisis, there has been a very rapid increase in savings, both in the BRI Units and in the rest of the BRI. In the Units, total savings have increased from Rp. 8.3 trillion at the end of October 1997 to Rp. 17.5 trillion at the end of May 1999. The speedup in the increase in savings is partly a flight to safety, even though all deposits at all banks have been guaranteed by Bank Indonesia." [Patten, 1999:10]

[Shari Berenbach in Craig Churchill: 11]

As with other commercial banks, negative spreads have eaten up the capital of BRI and the bank will have to be recapitalized by the government to remain in business. Besides negative CAR, BRI is also suffering from large non-performing loans in its corporate loan portfolio. International observers have raised concern about the effect of BRI's ill health on the Unit Desa system. To focus BRI's business for the future, the government has decided to model BRI into a pure retail bank with no corporate loans. This should make BRI more resilient and sharpen its corporate identity.

5. Bank Perkreditan Rakyat

5.1. History and clarification of the term Bank Perkreditan Rakyat

The term Bank Perkreditan Rakyat or simply BPR, refers to a variety of MFIs with different historic background, some deposit taking some credit-only, which the literature does often not distinguish properly. To better understand, what is meant by the term BPR and how it is used in this paper, some historical observations are presented below.

The Badan Kredit Desa

The Badan Kredit Desa (BKD) are considered as a special type of the BPR family (BPR – BKD). They were formed at the end of the 19th century under Dutch colonial rule in Java and Madura as so-called village banks and paddy banks (bank desa and lumbung desa) that are owned and managed by the village. These banks were started and run by both the colonial administration as well as Indonesian officials and individuals within the framework of the colonial "welfare policy". [Klaas Kuiper, 1999:4].[22]

Nowadays, these banks are referred to as the Badan Kredit Desa (village credit board, BKD). In 1929, the colonial administration officially recognized them in its "Staatsblad" on the Village Credit Institutions Act and put them under the supervision of the "Algemeene Volkscredietbank" (AVB-Bank) who also offered agricultural credit to these institutions.

The post-colonial Banking Law of 1967 did not further regulate these rural financial institutions[23]. However, the Ministry of Finance granted a collective business license to the BKD and regarded them as BPR. According to the law, all BPR are to be supervised by Bank Indonesia. However, considering their large number and the fact that the BKDs are not mobilizing deposits from the public, Bank Indonesia decided to entrust BRI with the supervision of BKDs thereby continuing an old tradition dating back to BRI's predecessor, the AVB-Bank.[24]

[22] Microfinance as a tool for poverty alleviation was popular in Indonesia well before the Microcredit Summit. The success of the rapidly expanding network of village and paddy banks relied on the fact that these banks were profitable. The colonial administration established the Volkscredietwezen Service (popular credit system service) and the Central Fund as apex organizations of these village banks, which merged in 1920. In 1934 the popular credit banks and the Central Fund merged into what was called the Algemeene Volkscredietbanks (AVB, general popular credit banks), which was later named Bank Rakyat Indonesia (BRI). [Klaas Kuiper, 1999:4 - 8]

[23] Article 4 of the 1967 law states the following: 1. Banks that received a working license before this act became operational, could continue their activities. 2. The status and activities of secondary banks will be regulated in a separate act. The new act to regulate these banks never passed parliament. Only in 1992, the general banking act distinguished between primary and secondary banks, which were named bank perkreditan rakyat (BPR). [Soeksmono, 1994:43]

[24] In 1951 the Ministry of Trade instructed BRI to take responsibility for 4,633 village and 3,621 paddy banks. [Charlesworth in Cole and Slade, 1996:144]. Article 7 of the 1968 BRI law states that the BKDs are to be supervised by BRI according to guidelines and directives from the central bank. The article also requires that BRI supervises market banks (bank pasar) and other similar types of financial institutions. [Soeksmono, 1994:44]. BRI is reimbursed by Bank Indonesia for supervising the BKD.

For the sake of this paper, the **BKD are not included in the term BPR** because they are fundamentally different from the other BPR both regarding their history, their size and their credit-only function (see also 2.2).

The Lembaga Dana Kredit Pedesaan
The generic term Lembaga Dana Kredit Pedesaan or LDKP (rural fund and credit institution) refers to various regional MFIs, most of them established between 1970 – 1990 by provincial administrations. LDKPs are somehow a post-colonial revival of the village bank movement mentioned above, which suffered a severe setback in the late 1960s due to monetary instability and high inflation causing widespread failures of these village banks. LDKP were established **as nonbank financial institutions**, most of them providing credit only.

The PAKTO 1988 deregulation package and the 1992 banking act introduced a new type of bank, the Bank Perkreditan Rakyat (BPR), which was designed as a microbank under central bank supervision. Subsequently, all LDKP and other financial institutions setup before were required to adjust to the new rules for BPR and seek a BPR license until October 1997.[25]

By the time the deadline for conversion to BPR was reached, about 27% of all LDKPs had been granted a BPR license.

The term BPR does thus include some 625 BPR ex-LDKP. Further reference to LDKPs is made below under 6.2.

BPR: old and new style
Old style BPR (BPR gaya lama) are all other rural banks that had been established before 1988. Some of them as market or trader banks, either privately or public owned. The bulk of the BPR are the so-called new style BPR (BPR gaya baru), which were founded after the deregulation of 1988. Most of them are in private hands, a few are setup as cooperatives.

Behind the term BPR we thus find 4 very different types of banks with their own characteristics, history, ownership, regulation and supervision. Table 3 provides an overview on those different BPR types. Further reference to BPR does not include the BPR-BKD, unless mentioned otherwise.

Table 3: Types of BPR

	BPR – BKD	**BPR ex LDKP**	**BPR old style**	**BPR new style**
Established since	*End of 19th century and onward as village and paddy banks*	Mostly 1971 – 1990, converted to BPR starting mid 1990s	End of 19th century and onward	1988 -
Location	*Java and Madura*	Java, West Sumatra, Bali, NTB,	Mainly Java and Bali	All Indonesia
Owner	*Local governments*	Local governments, traditional village	Private, local government	Private, cooperatives
Legislation	*Staatsblad 1929, Banking Act*	Banking Act, Presi-dent decree 71,1992	Banking Act	Banking Act
Regulator	*Bank Indonesia*	Bank Indonesia	Bank Indonesia	Bank Indonesia
Supervision	*BRI on behalf of Bank Indonesia*	Bank Indonesia	Bank Indonesia	Bank Indonesia
Number of units	*5,345 (3,289 village banks, 2,056 paddy banks)*	625	371 (132 Bank Pasar, 21Bank Desa 217 BKPD 1 Civil Servant Bank)	1,424
Financial	*Credit only*	Credit and deposit	Credit and deposit	Credit and

[25] See presidential decree (Keppres) No. 71, 1992.

5.2. *Profile of a BPR*

Main features

As of September 1999, Bank Indonesia reports a total of 2,420 BPR in Indonesia, mainly concentrated in Java and Bali (83%). BPR are generally owned by private individuals in the form of limited liability companies. A number of NGOs and commercial banks have set up their own BPR network. Sixty four BPR are registered as cooperatives. Seventy nine BPR follow the principles of Islamic banking. BPR are closed for foreign equity investment and are not allowed to maintain foreign currency accounts. BPR are effective financial intermediaries offering loans, savings and term deposits. Their loan to deposit ratio is generally close to 80%. Their average loan size is Rp 1 million, and average savings size is Rp 130,000. BPR are serving the middle segment of the microfinance market.
On an average, a BPR's assets are around Rp 1,500 million and the average client base is almost 3,000.

BPR products

BPR are authorized to offer 3 types of products: loans, savings and term deposits:

- Loans

The typical loans offered by a BPR are short-term microloans for petty traders ranging from Rp 100'000 to Rp 2 million, with 3 – 6 months maturities, daily installments, flat rates of interest in the range of 2-4% per month. In addition, BPR typically offer small loans in the size of Rp 1 – 10 million to productive businesses or for consumption purposes with maturities of 6 to 18 months, monthly installments, and generally flat rates of interest that might be slightly below the typical petty traders' loans described above. Agricultural loans are less frequently made and repayment schedules are usually adapted to the growing cycle. BPR rarely offer long term investment credits.
Overall loans outstanding for all BPR amounted to an average of Rp 2 million with a total of 2 million credit accounts.

- Savings

Savings are typically passbook savings. They allow unlimited withdrawal and offer rates of interest between 8% and 12% per year, which at the current one digit inflation rate translate into positive real rates. The average outstanding saving balance per account for all BPR is around Rp 170,000 with a total of 4 million accounts.

- Deposits

BPR offer time deposits, usually for periods of one, three, six and twelve months. The rates of interest fluctuate greatly depending on location, bank ownership, size and other factors. Current rates are around 10% - 13% per month. The average outstanding deposit balance per account for all BPR was Rp 4.3 million with a total of 224,000 accounts.

BPR performance

Current BPR performance is not satisfying. The industry suffers from a large number of less and unsound BPRs, whose already bad condition was further aggravated by the crisis. The aggregated BPR balance sheet per June 1999 shows a loss. In 1999, Bank Indonesia was forced to freeze the operations of 72 BPRs; more will follow in the coming months. Too rapid growth of the industry in the past has led to deterioration of BPR performance since 1993. The problems are rooted in weak management (low quality of human resources), low capitalization levels, lack of proper internal auditing and insufficient supervision. As a result, non-performing loans have achieved 37% of the portfolio by now[26].

[26] Non-performing loans in the commercial banks was estimated to have reached 60% during the peak of the crisis.

Although the overall picture of the BPRs is negative, a closer look shows that it is mainly the urban BPR that are in bad shape. Most of them are not sound.[27] Vicinity to and competition from the commercial banks has raised their cost of funds and eaten their margins. On the other hand, rural BPR operating in niche markets, especially those owned by the communities or with strong community links, have been doing rather well. Some of them have been able to increase their savings position, while maintaining their portfolio quality and increasing their margins.

5.3. Regulation and Supervision

All banks with a BPR license are regulated under the **banking act No. 7, 1992 revised by law No. 10, 1998**[28]. The banking act recognizes only two types of banks: the commercial banks or primary banks (bank umum, BU) and the people's credit banks or secondary banks (bank perkreditan rakyat, BPR). The fundamental difference between commercial banks and BPR is that the latter are excluded from the payment system, as they are not allowed to offer checking accounts. All banks are subject to supervision by Bank Indonesia. Supervision of BPR was an issue at the time the banking act was prepared. It was felt that Bank Indonesia should assume full supervisory responsibility of the entire banking sector, however, it was recognized that the supervision of thousands of BPR would be a cumbersome and expensive task with limited payoff in protecting the stability of the whole financial system. With the new central bank law No. 23, 1999, Bank Indonesia is to transfer the task of bank supervision of all banks to a new bank supervisory agency by the year 2002[29].

In **May 1999** Bank Indonesia issued a set of new regulations, substantially increasing minimum capital requirements[30] for new BPR and requiring existing BPR to hire two managers (four eyes principle) with at least a diploma 3 (D3) level and two years operational banking experience. It is the outspoken policy of Bank Indonesia to raise the entry barrier for new BPR in a situation where many BPRs are facing bankruptcy and will have to be restructured or liquidated[31]. Bank Indonesia envisages to have fewer but larger BPRs in the future. It is intended that by the year 2002, when Bank Indonesia will hand over supervision to the new supervisory agency, all BPR shall be sound. To achieve this goal, Bank Indonesia and GTZ have jointly developed a pilot project under the name ProFI that is providing technical assistance for strengthening and capacity building of small financial institutions[32].

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[27] Jakarta and surroundings alone counts 383 BPR, which make up 16% of the whole industry.

[28] In November 1998, the **banking act was revised**, giving more power to Bank Indonesia as regulatory **and** licensing authority, the latter of which was formerly with the Ministry of Finance. Besides, the basic regulations governing BPR remained unchanged, except that all banks (commercial and people's credit banks) are now required to participate in a deposit protection scheme. Currently, all bank deposits are guaranteed under a government blanket guarantee, which was originally meant to expire in January 2000. The regulation concerning the government guarantee stipulates that Bank Indonesia will have to announce the end of the guarantee with 6 months notice. Since there was no notice given until to date, the guarantee will continue beyond January 2000. Bank Indonesia and GTZ are currently preparing the ground for establishing a private deposit protection for BPR, which shall come into effect in mid 2000.

[29] The Indonesian government was advised by the former president of the German Bundesbank, Prof. Schlesinger, who advised the government to separate the functions of bank regulation and supervision from the typical monetary goals of a central bank. The proposal evoked fierce opposition in parliament and from Bank Indonesia, both anticipating difficulties in coordination between the central bank and a new bank supervisory agency as a major reason for retaining bank supervision within Bank Indonesia. After extended debates over a period of 2 months a compromise was reached according to which Bank Indonesia is to retain its bank regulatory functions but will transfer its supervisory power to a new body, which is still to be created.

[30] The new regulation allows BPR to operate in urban areas but increases minimum capital requirement for new BPR in the wider area of Jakarta (Jabotabek) to 2 billion Rupiah, in other provincial capitals to 1 billion Rupiah and to 500 million Rupiah in all other areas.

[31] Between 1992 and the end of 1998, 60 BPR were closed and their license withdrawn. In 1999, the operations of 72 BPRs have been frozen and will be liquidated. Deposits will be paid to customers under the government guarantee scheme.

Prudential regulation, supervision, and reporting requirements for BPR are similar to those for commercial banks. Bank Indonesia has simplified and adapted the CAMEL tool for commercial banks to the requirements of BPRs. BPRs are classified into four categories: sound, fairly sound, less sound and unsound. The rating is based on off-site supervision by analyzing standardized and computerized monthly reports prepared by the banks (balance sheet, loss and profit, loan classification). On-site supervision is ideally undertaken once a year per BPR to verify reports and check on management. However, in practice, on-site supervision is undertaken less than once a year per BPR due to limited bank supervisory staff in Bank Indonesia. Bank supervision is fully decentralized and executed by 41 BI offices in 26 provinces. The CAMEL rating is prepared by the respective BI office. The directorate of BPR supervision in Jakarta is collecting all reports from the provinces and prepares aggregate figures for the whole industry. It decides on withdrawal and issuing of new licenses for BPR after consultation with the BI office in the province.

The BPR CAMEL rating is composed and weighted as follows[33]:

C for **Capital** is weighted with **30%** and is measured by the capital adequacy ratio, which is mandated to reach at least 8% to qualify for the rating "sound". Capital is composed of core capital (paid-up capital, reserves, profit retained, goodwill) and additional capital (reserves for revalued fixed assets, loan loss provisions, quasi equity, subordinated loans) and compared to risk weighted assets.

A for **Productive Asset Quality** is weighted with **30%** and is measured by two ratios: a) classified assets to productive assets (25%) and b) effective reserves against mandated reserves (5%). The first ratio measures portfolio at risk using a rather complicated aging of all productive assets into 4 categories (pass, doubtful, sub-standard, loss)[34], which takes into account different installment periods (daily, weekly, monthly, seasonal). A loan with monthly installments is considered "pass" until repayment is 90 days overdue and becomes doubtful only on day 91 to day 180. The second ratio measures effective versus mandated provisioning for loans and is thus not really measuring loan quality but rather compliance to the provisioning rules.

Table 3: Mandated Loan Provisioning

	pass	sub-standard	doubtful	loss
Mandated Loan Provisioning	0.5%	10% of loans in this category after deduction* for the value of collateral	50% of loans in this category after deduction* for the value of collateral	100% of loans in this category after deduction* for the value of collateral

* 100% may be deducted for liquid collateral and 75% of other collateral or as valued by a valuator

M for **Management** is weighted with **20%** and is measured during on-site supervision by using a questionnaire that evaluates 25 aspects with reference to general management (10 questions) and risk management (15 questions).

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[32] ProFI aims to strengthen the bank-administrative capacity of small financial institutions of the BPR (*Bank Perkreditan Rakyat*, People's Credit Bank) and LPD type. In this respect, the following are the primary targeted results:
- Strengthening the BPR association PERBARINDO;
- Building up an association structure for LPD which are seeking to obtain bank status;
- Introduction of a deposit protection scheme;
- Improvement of refinancing for BPR/LPD;
- Adjustment of bank supervision by Bank Indonesia to an increasing self-regulation by the BPR associations.

[33] See Circular Letter No. 30/3/UPPB, 30 April 1997.

[34] Since November 1998, Bank Indonesia has introduced the new category "special mention" for commercial bank loans overdue 1 – 90 days. However, this regulation has not been adopted for BPR, where only 4 categories are used.

E for **Earnings** is weighted with **10%** and is measured by two ratios: a) profit before tax during the last 12 months compared to average business volume within the same period (5%) and b) operational cost during the last 12 months compared to operational income in the same period (5%).

L for **Liquidity** is weighted with **10%** and is measured by two ratios: a) loan deposit ratio (5%) and b) quick ratio comparing liquid assets to current liabilities. LDR of 95% is regarded as sound.

Each of the above components is quantified using a reward system running from 0 to 100 and then weighted according to the assigned weight above. Banks achieving 81 – 100 points are regarded as sound, 66 – 80 as fairly sound, 51 – 65 as less sound and below 51 as unsound. A bank being exposed to internal conflicts, outside interference in management, window dressing or being involved in other unlawful bank activities is automatically regarded as unsound.

5.4. Main issues in BPR Regulation and Supervision

The **BPR regime seems to be unique** in the world of microfinance. The Indonesian government has explicitly recognized the importance of microfinance and has provided a competitive regulatory framework. This has greatly facilitated entry into this market and has based microfinance on firm commercial grounds rather than on continued donor support. However, the rapid growth of the industry coupled with shortcomings in the supervision of BPR have led to a high percentage of unsound BPR, which are now on the brink of collapse and will eventually have to be bailed out under the government's deposit guarantee. Improved supervision is thus required to guarantee the quality of people's credit banks and preventing them from becoming insolvent. An effective and efficient supervision is a must and a conditio sine qua non for the functioning of a future deposit protection scheme that shall be based on self-financing rather than on government bailouts.[35]

The large percentage of BPRs classified as less sound (14,7%) and unsound (28,1%) has lead to question the appropriateness of the current regulatory framework and supervisory practice for microbanks.[36] Costs for supervision of BPR compared to their asset size are high. To remedy the situation, Bank Indonesia with the support of GTZ has embarked on some crucial projects to strengthen microbanks:

1. Deposit protection

Deposit protection for all banks is mandated by the revised banking act of 1998. For BPRs, it is proposed to establish a private limited liability company jointly owned by Bank Indonesia and the association of BPRs, Perbarindo. A simple but effective risk rating instrument is going to be developed to assess fees and monitor member banks.

2. Human resources development

A diploma for BPR managers is envisaged as part of the "fit and proper test" for future BPR managers. Perbarindo will play a crucial role in this project and be represented in the provincial standard boards.

3. Improved bank supervision

The current practice and tools will be thoroughly reviewed and revised. ProFI is exploring the possibility of introducing the concept of risk rating as an alternative to the present CAMEL tool applied to BPR supervision. The BPR CAMEL tool has been criticized for not adequately reflecting the status of the main asset of a BPR, i.e., its loan portfolio. Loan classification might need to be reviewed and made more stringent. More frequent on-site reviews are required to undertake well-organized and systematic portfolio audits. Liquidity requirements appear to be rather low for unsophisticated BPR with a term structure dominated by few but relatively large deposits and a large number of relatively

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[35] Sixty six years ago, Thomas A Fruin, the "microfinance" Advisor to the Dutch colonial government made very similar observations regarding regulation and supervision of village banks. [see Klaas Kuiper, 1999]

[36] BPR classification per June 1999: sound = 42.5%, fairly sound = 14.7%, less sound = 14.7%, unsound = 28.1%.

small saving accounts that can be withdrawn without notice. Cash-flow based liquidity management is required. A standardized instrument is not yet available.
A prototype for BPR risk rating named KOMODO has been developed by a private nonbank finance company sponsored by USAID and executed by CRS[37]. Risk rating will be gradually introduced as a tool for risk assessment within the new deposit protection scheme for BPR, mentioned above. Risk rating under the planned private deposit protection scheme could thus gradually complement the Bank Indonesia CAMEL rating and eventually replace it.

4. **Strengthened BPR association**
Self-regulation is clearly an issue, but not much has been done so far to stimulate it. The association of BPR, Perbarindo, would be the ideal institution to complement Bank Indonesia's supervisory function with increased self-regulation. However, Perbarindo has still to go a long way to qualify itself in the eyes of member banks as well as central bank before it could be entrusted with such a task. Through the participation of Perbarindo in the above strategic projects, Perbarindo will further qualify itself.

6. Lembaga Dana Kredit Pedesaan

Lembaga Dana Kredit Pedesaan (LDKP) or rural fund and credit institutions have been referred to as nonbank financial institutions. Most of them were established before 1988, when the ban on opening new banks was still in force. The pioneer Badan Kredit Kecamatan (BKK) in Central Java were established by the Central Java administration to complement the security approach of Suharto's new order regime with a prosperity approach[38]. BKK were conceived as credit institutions since the target group, the rural poor, were deemed too poor to save and since the BKK had no bank license that would allow them to mobilize savings from the public. However, BKKs introduced mandatory savings to educate the poor to the value of savings[39]. Growth was fueled by retained earnings and initial loans from the government. Since BKKs were not regulated by the central bank[40], they were free to set profitable interest rates that enabled them to reap a profit big enough to allow for substantial growth. After ten years, there were 486 BKK units, which hat extended 2,5 million loans worth Rp. 31 billion. [Soeksomono, 1994: 16; Patten and Rosengard, 1991:2, 41] This success inspired other governments to study the BKK experience and to adopt a similar approach in their provinces. Bali was most successful with the establishment of the Lembaga Perkreditan Desa (LPD) beginning in 1985. The LPDs have demonstrated extraordinary strength in mobilizing savings from the villagers by introducing voluntary savings at an early stage. Other than the BKK, LPDs are owned by the traditional village (desa adat) and not by the local government, which explains to some extent their success in savings mobilization.

All provinces in Java finally set-up their own version of LDKP, followed by NTB, some provinces in Sumatra (West Sumatra, Riau, Bengkulu, Aceh) and South Kalimantan.[41] The results were somehow

[37] KOMODO investigates the following areas in a BPR: 1) governance and management, 2) business environment, 3) procedures and internal control, 4) accounting and MIS, 5) financial statements, 6) asset quality and specific risks, 7) financial performance. It is applied through a software that creates a standardized rating report comparing the performance of the reviewed BPR with peer data. The rating is then expressed as a percentage of compliance with KOMODO standards.
[38] In the sixties galloping inflation in Indonesia destroyed most cooperatives and rural financial institutions and contributed to the fall of the Sukarno administration.
[39] A pilot project experimenting with voluntary savings produced good results but was obviously not further persued by the BKKs [Patten and Rosengard, 1991:2]. It was only much later, with the introduction of the TAMADES savings account in 1987 and after being granted permission to mobilize savings by the Ministry of Finance that the BKK seriously started to promote savings mobilization . [Patten and Rosengard, 1991:38-39]
[40] Indonesian banks were only allowed to charge market rates of interest after the promulgation of the PAKJUN deregulation package of 1 June 1983.
[41] The Central Java administration founded the Badan Kredit Kecamatan (BKK) in 1970, the West Java administration sponsored the Lembaga Perkreditan Kecil (LPK) in 1971, Bali came next with its Lembaga Perkreditan Desa (LPD) in 1985, followed by East Java's Kredit Usaha Rakyat Kecil

mixed. The outstanding examples are the BKK in Central Java and the LPD in Bali. Statistics about the performance of the various LDKP are not readily available, except in Bali and Central Java.

All in all, more than 3,000 LDKPs were founded in 12 provinces and some 2,300 survived. Of those surviving LDKPs 625 (27%) converted to BPR until the expiration of the deadline – October 1997 – set by the presidential decree No. 71, 1992, for LDKP conversion to BPR:

1. In NTB 46 (78%) out of 59 LKPs became BPR,
2. in South Kalimantan 20 (67%) out of 30 LDKPs graduated to BPR status,
3. followed by Aceh with 12 (63%) out of 19 LKKs,
4. West Java with 40 (41%) out of 98 LPKs,
5. East Java with 67 (36%) converted KURKs out of 186,
6. Central Java with 346 (35%) out of 982 BKK,
7. Jakarta with 22 (23%) out of 97 LDKPs,
8. Riau with 1 (17%) out of 6 LDKPs,
9. West Sumatra with 71 (12%) graduated LPN out of a total of 569[42].

[Data per June 1999, by Bank Indonesia]

Bali (LPDs), Yogyakarta (BUKP) and Bengkulu (BKK) are reporting that none of their LDKPs was converted to BPR status.

The percentage of converted LDKPs into BPRs does not tell us much about the quality of the respective LDKPs or BPR ex-LKDP. The 910 LPDs in Bali opted decidedly against applying for BPR status, although many would have qualified and would be considered sound under Bank Indonesia's CAMEL rating. On the other hand, some LKPs in NTB got converted although their current classification as BPR marks them as unsound.

Per June 1999, Bank Indonesia estimates the total number of LDKP to be 2,272.

Generally, rural fund and credit institutions are owned by the local governments and supervised by the Bank Pembangunan Daerah (BPD), the Regional Development Banks, who also provide technical assistance. The quality of this supervision and technical guidance varies greatly from province to province.

6.1. Badan Kredit Kecamatan: from credit-only to financial intermediary

History

The BKKs were founded in 1970, during a time of monetary austerity, primarily targeting the rural poor. BKKs received an initial Rp. 1 million loan from the provincial government channeled through the BPD, which had to be repaid within 3 years with one year grace period, at 1 percent per month. Following the motto "fast, cheap and productive credit", right from the beginning, the BKKs were forced to operate profitably to be able to repay their loans and pay for the supervision costs of BPD. Savings were not conceived as a major source of funds for the BKKs, a view that was confirmed by the central bank which banned nonbank financial institutions form accepting savings in 1973 after the high inflation of the sixties had wiped out the savings of rural folks in many village banks and cooperatives. [Patten and Rosengard, 1991: 25, 94] The Ministry of Finance made an exception to this policy in 1984 and allowed BKKs to accept public savings. However, BKKs were rather slow in reacting to this opportunity.

(KURK) in 1987 and the Lembaga Kredit Desa (LKP) in NTB. The Lumbung Pitih Nagari (LPN) in West Sumatra had already been established since 1911 under the colonial "Volkscredietwezen".

[42] The number of active LPN is presently estimated at 121 only [W. Hiemann].

Profile

There are now 778 BKK units in Central Java operating an estimated 4000 village posts (pos desa). A typical BKK office consists of 5 – 10 staff, equipped with motorcycles, a small office building with simple furniture. A unit runs 5 – 7 village posts, which open on certain days of the week or sometimes only once a month, according to the installment periods of loans made at that post. Village post accounts are consolidated at the BKK.

In December 1998, BKKs had a total of Rp. 96 billion in loans outstanding in 294,000 loan accounts. The average outstanding BKK loan amounts thus to Rp. 325,000. Savings amounted to Rp. 66 billion in 440,000 accounts, resulting in average savings per account of Rp. 150,000. [Based on information collected by Dirk Steinwand]

BKKs are able to borrow from and place their excess funds in the BPD.

BKKs apply the now typical instruments of microcredit: loans are unsecured and character-based, relied on references from local officials rather than based on feasibility studies of a proposed project or enterprise. Initial loans are small and gradually increased, based on repayment performance. This mechanism functions as the primary repayment incentive. Loans are paid in equal installments, carrying maturities from 22 days to 12 months, according to six different repayment plans with monthly effective interest rates ranging from 2.2% to 10.8%. Savings are mandatory for every loan and are treated as cash collateral, becoming accessible only after full loan repayment.

Accounting and administration is uniform for all BKKs and developed by the BPD.

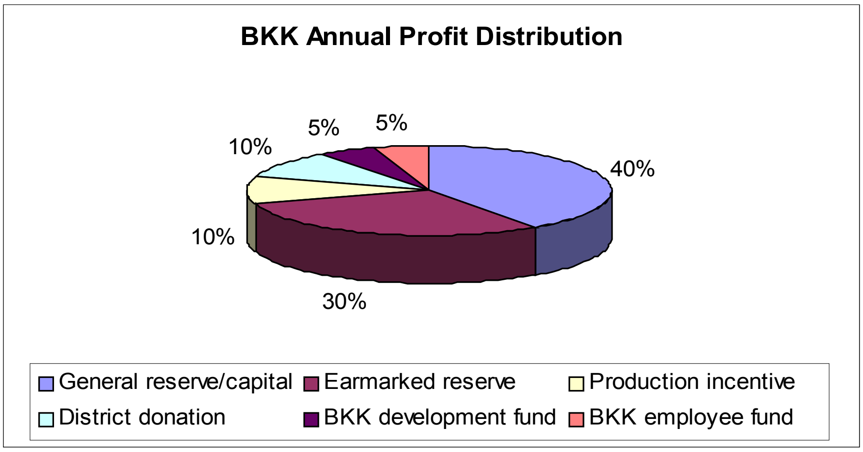
It is difficult to judge the recent growth and performance of the BKK as an industry, since 35% of all BKK became BPR and do not figure anymore in the aggregated BKK statistics. Real growth in lending for the years 1986 – 1989 was declining from 12.5% (1986) to 6.3% (1989).

The quality of the loan portfolio was reported to be good with a long-term loss ratio (total amount overdue compared to total amount due) of 2.1% and an arrears rate of 7.4% (arrears to total loans outstanding) at the end of 1989. There is no reason to believe that performance has slowed down in the following decade. [Patten and Rosengard, 1991: 40-43]

It is noteworthy, that the BKK received various types of concessional loans and substantial technical assistance under the USAID's PDP and FID projects. Yaron's subsidy dependency index for BKK in 1989 amounted to 20%, meaning that BKKs on-lending rates would need to be increased by 20% to eliminate all subsidies. Effective rates of lending would thus need to be increased to 3.9 – 7.9% per month or 47 – 90% annually, depending on the type of loan. Even at those levels, the BKK rates would still be attractive compared to the informal sector charging rates between 150 – 180% annually. However, if subsidies were withdrawn in 1989, the industry would have been slightly in the red. [Soeksmono, 1994:77-80]

BKKs divide their profits following a uniform system valid for the whole industry as follows:

Illustration 2: BKK Annual Profit Distribution



By the end of 1989, BKKs had retained earnings amounting to 37% of total assets, achieving a coverage of 41% of all villages in the province and reaching 34% of the rural poor. [Patten and Rosengard, 1991:50, Soeksmono, 1994: 83] The majority of BKK borrowers are women.

Regulation and Supervision

Since BKKs are owned by the provincial government, they report to the sub-district head, which represents the government at that level and acts as the ex-officio manager. He is responsible for "his" BKK's performance. Overall responsibility rests with the governor of the province. Supervision of the BKKs is with the regional development bank. Full-time BPD staff visit each BKK at least once a month to provide technical support and on-site supervision.

BKKs are classified semiannually according to a system of 6 weighted factors:

- Total equity (50%)
- Ratio of villages to village posts (10%)
- Number of new borrowers (10%)
- Portfolio quality (10%)
- Total savings (10%)
- Capital circulation (10%)

[Patten and Rosengard, 1991:32]

Based on these criteria, 5 classes are defined, which the BPD uses to assign credit ceilings and as an early warning system to detect problems in particular BKKs. In 1989, 31% of BKK were in class I, 31% in class II, 28% in class III, 8% in class IV and 1% in Class V. [Patten and Rosengard, 1991:35]

Main issues in Regulation and Supervision

Main issues for BKK regulation and supervision seem to be of technical nature involving loan classification, provisioning and BKK rating. The above BKK classification system is geared to measure absolute size and outreach (equity, savings, borrowers, capital circulation) rather than assessing bank soundness according to the typical ratios (CAR, liquidity, provisioning, earnings etc.) and based on a specific risk profile. Portfolio quality, for instance, representing the most crucial factor for BKK soundness is weighted with 10% only, which seems to be highly inadequate. Loan classification should be revised to reflect the nature of BKK loans, which are mostly short-term with frequent installments and a clear write-off policy is required for the whole industry.

The role of BPD as the BKK supervisor is somehow a difficult one, since the BPD lacks clout to enforce regulations, mainly when it comes to sensitive issues involving the management of a BKK. There is a typical conflict of interest within the BKK system of governance: the owner of the BKK, i.e., the local government is also the manager of the BKK and also owns the institution that is in charge of supervision, i.e., the BPD.

As a nonbank financial institution, the task of reviewing the above points would naturally rest with the owners. However, since BKK are a deposit taking nonbank, thus virtually the same as a BPR, Bank Indonesia might consider to coordinate such a task and involve other LDKPs as well.

6.2. Lembaga Perkreditan Desa in Bali: public versus member based deposit-taking

History

In February 1984, the Ministry of Home Affairs chose the cradle of the BKK to organize a seminar on how to provide credit to the rural poor and to microentrepreneurs that were not yet reached by formal financial institutions. The seminar in Semarang brought together high-ranking representatives from various provinces. It inspired the first governor of Bali to launch a pilot project establishing one Lembaga Perkreditan Desa (LPD) in each of the 8 districts of the province. In 1988, the provincial decree (peraturan daerah) No. 2 provided the legal basis for the LPD, rooting them firmly within the traditional village communities (desa adat[43]) and their associations (sekehe).

The traditional village (desa adat) is the owner of the LPDs, not the government. LPDs are designed not only to serve purely economic goals but to contribute to maintain the desa adat and its system of associated temples. Every LPD is based on the written customary law (adat, awig-awig) of the community, which provides the code of conduct and spells out sanctions for its members.

From 1990 – 1992, the LPDs received technical assistance under the USAID sponsored FID project. Since 1999, GTZ supports LPDs through its pilot project ProFI.

Profile

LPDs are fairly autonomous units and were designed as financial intermediaries form the very beginning, although limited to the boundaries of the traditional village community. Nowadays, 910 LPDs exist in Bali's 1,371 desa adat communities. It is the goal of the local government to further expand the system until every community has its own LPD. The number of LPDs has been growing at an average annual rate of 6% and their total assets grew by 34.5% annually in the last seven years. LPDs reach 545,000 clients of a total of 2.8 million inhabitants of Bali. More than five out of six households are somehow linked to the LPD system. In terms of outreach, the LPDs seem unrivaled in Indonesia and maybe worldwide.

The size of LPDs differs greatly, reflecting the economic potential of the respective community. There are 24 large LPDs with assets above Rp. 1 billion, much larger than the average BPR. The average size LPD has assets worth Rp. 280 million, is operated by 5 staff, serving 600 customers.[44] The industry is highly profitable reaching 10% ROA and 60% ROE in 1998. Income is derived almost entirely from lending.

LPDs rely on savings and deposits rather than on credit and grants as their source of refinancing. They have been very successful in mobilizing savings. The system is slightly overliquid with Rp. 170 billion in loans outstanding compared to Rp.182 billion in savings (LDR = 95%). BPD acts as the banker of the LPDs, absorbing overliquidity and providing credit when needed. LPDs offer passbook savings

[43] The provincial government has officially recognized the desa adat in decree No. 6, 1986, thereby regulating role and function of these communities as legal entities based on written customary law (awig-awig) that have been transmitted over generations on lontar leaves. The desa adat runs parallel to the modern Indonesian administrative entity at village level, i.e., the desa, which is subordinated to the sub-district (kecamatan), the district (kabupaten) and the province (propinsi).

[44] All figures on LPD are per June 1999 if not indicated otherwise. Source: Bank Pembangunan Daerah Bali.

accounts and deposits at market rates. Credit is short-term with frequent installments and mostly used to finance working capital. The average outstanding loan is Rp. 860,000, the average savings account Rp. 200,000 and average deposits are Rp. 2.3 million. Lending procedures are character and membership based. A recommendation from the adat chief is required. In principle, LPDs are only to serve adat community members. In practice, however, the large LPDs in urban and semi-urban areas do also serve non community members to which their adat rules do not apply. Peer pressure within the desa adat is responsible for high repayment rates. Delinquent borrowers risk to be expelled from their community and lose their right to pray in the village temples. This is regarded as a severe sanction with many negative implications for the offender.

Loans are classified according to the Bank Indonesia standards in 4 categories: pass, doubtful, sub-standard and loss. The current position of the aggregated loan portfolio is:

Pass: 87.74%
Doubtful: 6.42%
Sub-standard: 2.14%
Loss: 3.7%

BPD classifies LPD according to a simple CAMEL rating in 4 categories. LPDs are currently classified as below:

Sound: 589 (65%)
Fairly sound: 170 (19%)
Less sound: 95 (10%)
Unsound: 56 (6%)

It is often said that the soundness of a LPD is a direct indicator of the strength of the local adat.

A team of at least three people (badan pengurus) consisting of a chairman, a cashier and a secretary manages LPDs. Additional staff may be hired as field officers and for administration if required. The LPD is controlled by the chief of the desa adat, who represents the village community, i.e., the owner of the LPD.

Distribution of profits is uniform for all LPDs and follows a similar pattern as in the BKK system.[45]

Regulation and Supervision

Although owned by the desa adat villages, the government and the government owned BPD continue to play an important role in the LPD development as father and promoter. To fulfill its guidance, supervisory and auditing role, the government has installed a guidance and supervisory body of the LPDs (Badan Pembina LPD) at provincial, district and sub-district level. This body is presided by the governor himself and consists of his representatives at lower levels as well as representatives from BPD. The government has also ruled that LPDs would be audited by the regional inspectorate (Inspektorat Wilayah Daerah)[46]. Technical guidance and supervision is entrusted to the BPD by analyzing monthly LPD reports and by carrying out on-site visits[47]. Besides, the government has installed so called LPD Centers (Pusat Lembaga Perkreditan Desa Kecamatan, PLPDK) at sub-district level[48], which are supposed to support BPD's function. There are currently 64 staff posted in 16 PLPDKs, financed by a part of the profit (5%) of the LPDs[49].

[45] General reserves/capital: 40%, earmarked reserves: 20%, village development fund: 20%, production incentive: 10%, guidance fund: 5%, social fund: 5%.
[46] See governor's decree No. 2, 1988 and governor's decision No. 242, 1992.
[47] See also governor's decree No. 344, 1993.
[48] See governor's decree No. 180, 1989.
[49] See governor's decision No. 100, 1989 and No. 13, 1990.

Off-site supervision is carried out through the analysis of standardized monthly reports consisting of balance sheet, loss and profit account and a loan classification report, which are provided to BPD and the government. Based on this report, on-site visits are scheduled and carried out at least once a year per LPD.

Main issues in Regulation and Supervision

The different tasks of all the institutions involved in LPD regulation and supervision (local government on provincial, district and sub-district level, BPD, PLPDK, regional inspectorates) are not clearly defined and are sometimes overlapping. There is need for clarification and delineation of competence and tasks to streamline supervision and increase its efficiency.

Referring to the banking act No. 1992, paragraph 58, the central government has issued decree No.71,1992 requiring all LDKP to seek BPR status by October 1997. This date has lapsed without any of the LPDs applying for BPR status. The government and LPDs are defending their position by citing various reasons, but mainly referring to the bad reputation and performance of BPRs in Bali under Bank Indonesia supervision versus the good performance of LPDs under the supervision of the local government. Anticipating the deadline for conversion, the Bali Governor and the Ministry of Home Affairs have repeatedly called on the Ministry of Finance and Bank Indonesia to forward their cause. In a letter dated 25 February 1997 the Ministry of Finance responded to the LPDs request to continue operations without having to transform to BPR[50], stating that LDKPs that do not apply for a BPR license shall be permitted to continue to operate, however they would have to refrain from mobilizing savings from the public. Exchange of views and opinions between the different stakeholders has continued until today. Recently, Bank Indonesia, who is now responsible for bank licensing, has taken the following stance[51]:

> Existing LPDs that are performing well shall continue to operate. However, since LPDs are not considered to be banks, they are not allowed to undertake banking business. In savings mobilization, LPDs shall limit themselves to the members of the adat community and refrain from using bank terms to designate their products.

It seems that this compromise accommodates most of the concerns of both sides. It poses some difficulty, however, for the large urban and semi-urban LPDs that got used to providing services to non adat community members as well. For the supervisors, it will pose an additional difficulty to assess whether savers belong to the adat community or not.

The main concern of the regulator is to safeguard public deposits. As total deposits of all LPDs exceed deposits mobilized by all BPR in Bali, it seems crucial to set some limit to the deposit taking of non-banks in Bali or find another solution to protect public deposits. Limiting LPDs to mobilizing savings from within the adat community only, makes sense insofar as the adat community owns the LPD and is thus responsible for its performance. The community and its members have the right to interfere in LPDs internal affair and exercise control over management. Outsiders are facing the problem of adverse information on the status of an LPD and are not able to influence management. They should be protected. Excluding them from access to LPD services and thereby requiring supervisors to make sure that this rule is followed is one way of dealing with the issue. This instruction of the regulator has not been implemented so far and has met some resistance. Establishing a deposit protection scheme similar to the one currently in design for BPRs could solve the problem as well and be in the interest of all parties involved. All LPD taking deposits beyond the boundaries of the adat community would thus automatically require membership in a deposit protection scheme designed according to standards issued by Bank Indonesia, making sure that depositors' protection in LPDs and BPRs would be equal. Such a regime would somehow lift LPDs to the level of BPRs without placing them under BI supervision but still guaranteeing the safety of public deposits.

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[50] See letter No. S-904/LK/1997 by Directorate General of Financial Institutions of the Ministry of Finance.

[51] Bank Indonesia, 17 February 1999.

7. Cooperatives

The first cooperatives in Indonesia date back to the colonial period. The Indonesian constitution states that cooperatives shall be one pillar of the national economy. Hence, cooperatives have a special place in the state ideology, Pancasila. The government sponsored Koperasi Unit Desa (KUD) have gained much attention and support during the new order regime of former president Suharto and were established all over the country. However, or one might rather say, therefore, coops in Indonesia never developed into true people's institutions, but were always regarded as instruments of the government to control the rural masses and implement its rice production targets. The government has used the KUDs to channel various subsidized loan and farm input programs to farmers. Some of the schemes were designed to produce losses by their very design. Besides the rather bleak results in cooperative development, there are some thrift and loan units within the KUDs that have developed rather well, thanks to the absence of any intervention from the former ministry of cooperatives.

Truly independent, grassroots cooperatives had a difficult time to obtain a license and only recently some liberalization has taken place to stimulate growth of other coops than the KUDs. The credit union movement in Indonesia has never gained much prominence, although it was finally recognized and granted a legal body by the authorities. Other saving and loan cooperatives have sprung up locally, especially a few women cooperatives have established a good reputation.

The so called Koperasi Simpan Pinjam (KOSIPA) have more often been established for individual motives than for true self-help. Their reputation is controversial. People see them as a disguise for moneylenders to conduct their business under a legal entity.

All in all, cooperatives still play a minor role within the field of microfinance in Indonesia.

8. Executive Summary

This paper attempts to present an overview on history and the present state of microfinance institutions in Indonesia seen with the eyes of a bank regulator. It is stressed that "the world's largest scale, variety and volume of MFIs" is a result of 100 years development. In Indonesia, microfinance is the modern term for what used to be the "Volkscredietwezen" (popular credit system) established at the end of the 19th century under Dutch colonial rule. With hindsight, one might say, that this could be the most important legacy from 350 years of colonialism for overcoming modern Indonesia's problems with poverty and economic disparity.

The actual landscape of MFI is presented and divided into a formal, semi-formal and informal sector. The formal sector's contribution to microfinancial services is outperforming the semi- and informal sectors in terms of loans outstanding and savings as well as in number of clients. This is in line with results of a recent survey on the size of the worldwide MFI industry, which indicates that commercial and savings banks are responsible for the largest share in outstanding loans and deposits, whereas NGOs and credit unions contribute only marginally.[52]

The MFI customer pyramid is introduced as a concept to distinguish the different market segments of MFIs in Indonesia. BRI's 3,703 Unit Desa serve the upper segment with average loans outstanding around Rp. 2 million and slightly more than 23 million borrowers and savers. The middle segment is served by 2,420 peoples credit banks (BPR) with average loans outstanding at Rp. 1 million, serving about 4.2 million customers. The lower segment is targeted by the rural fund and credit institutions (LDKP), cooperatives and NGO projects with average loans well below the BPR and a customer base estimated to range between 2 – 3 million people. At the lowest end are state pawnshops serving 10 million clients with average loans outstanding of Rp. 80,000.

The paper argues that consumer protection is the ultimate rationale of regulation and supervision for commercial banks as well as for MFIs. Protecting depositors becomes thus the main end of regulation

[52] The World Banks Sustainable Banking with the Poor Project compiled a worldwide inventory of MFIs between 1995 and 1996. [Ledgerwood, 1999: 3]

and supervision. However, in practice the apparent clear-cut between deposit taking and non deposit taking MFIs is difficult to make. Indonesia has chosen a multi-agency and tiered regulatory framework for MFIs and a so called hybrid approach to MFI supervision that is based on the size and type of MFI's deposit taking activities.

Generally, all public deposit taking MFIs in Indonesia are regulated under the banking act and have to fulfill the criteria of a BPR. Indonesia has not promulgated a special MFI law, but has adjusted its banking act to accommodate a certain type of MFI. Out of 13,740 microbanks, Bank Indonesia (BI), who is responsible for bank regulation and supervision until the year 2002, is overseeing directly some 2,420 BPR. The central bank has concluded special arrangements with other institutions to supervise on BI's behalf. Bank Rakyat Indonesia (BRI) is supervising 5,345 credit-only BKDs (village credit boards) on behalf of BI and is reimbursed for this task. The regional governments and the Regional Development Banks (BPD) are supervising 2,272 LDKP (rural fund and credit institution), some of which are limited deposit taking MFIs.

The paper provides a profile of the most important MFIs in Indonesia and discusses issues concerning their regulation and supervision. The focus is on the BPR, which are directly supervised by BI. It is argued that the entry barrier for BPR was initially set too low. Rapid growth of the industry, coupled with shortcomings in the supervision of BPR have led to a high percentage of unsound BPR. To remedy this situation, Bank Indonesia and GTZ (German Technical Assistance) have launched a joint pilot project name ProFI, which is, among else, developing improved regulatory and supervisory tools for the BPR. The main focus of ProFI is on:

1. Deposit protection
Deposit protection for all banks is mandated by the revised banking act of 1998. For BPRs, it is proposed to establish a private limited liability company jointly owned by Bank Indonesia and the association of BPRs, Perbarindo. A simple but effective risk rating instrument is going to be developed to assess fees and monitor member banks.

Deposit protection is also an issue for public deposit taking nonbanks of the LDKP type, especially the LPD in Bali.

2. Human resources development
A diploma for BPR managers is envisaged as part of the "fit and proper test" for future BPR managers. Perbarindo will play a crucial role in this project and be represented in the provincial standard boards.

3. Improved bank supervision
The current practice and tools will be thoroughly reviewed and revised. ProFI is exploring the possibility of introducing the concept of risk rating as an alternative to the present CAMEL tool applied to BPR supervision. The BPR CAMEL tool has been criticized for not adequately reflecting the status of the main asset of a BPR, i.e., its loan portfolio. Loan classification might need to be reviewed and made more stringent. More frequent on-site reviews are required to undertake well-organized and systematic portfolio audits. A prototype for BPR risk rating named KOMODO has been developed by a private nonbank finance company sponsored by USAID and executed by CRS. Risk rating will be gradually introduced as a tool for risk assessment within the new deposit protection scheme for BPR, mentioned above. Risk rating under the planned private deposit protection scheme could thus gradually complement the Bank Indonesia CAMEL rating and eventually replace it.

4. Strengthened BPR association
Self-regulation is clearly an issue, but not much has been done so far to stimulate it. The association of BPR, Perbarindo, would be the ideal institution to complement Bank Indonesia's supervisory function with increased self-regulation. However, Perbarindo has still to go a long way to qualify itself in the eyes of member banks as well as the central bank before it could be entrusted with such a task. Through the participation of Perbarindo in the above strategic projects, Perbarindo will further qualify itself.

The paper further explores regulatory issues concerning two types of rural fund and credit associations (LDKP), the BKK in Central Java and the LPD in Bali. These two LDKPs are most interesting because they are deposit taking nonbanks. The BKK gradually developed from credit-only to financial intermediaries with special permission from the Ministry of Finance to mobilize savings. As foreseen in the banking act, LDKPs are expected to graduate into BPR. So far 345 BKK have successfully applied for a BPR license, whereas about 637 BKKs continue to operate as nonbanks. The LPD in Bali have opted to challenge the banking act by not applying for a BPR license. The obvious reason for doing so is the fact that BPRs in Bali are suffering from a bad public image due to the failure of several BPRs in the recent past and the overall weak performance of the BPR in Bali. The banking authorities in Jakarta have agreed that LPDs should continue their activities as nonbanks, however, deposit taking shall be limited to the village (desa adat) boundaries. So far, this instruction has not yet been implemented and seems to meet some resistance. The paper proposes another solution to safeguard public deposits in these "village banks" by introducing a private deposit protection scheme similar to the one in preparation for BPRs. This solution would have the advantage to leave LPDs under the existing and proven supervisory framework without curtailing the financial intermediation of LPDs. In view of Bank Indonesia's current policy of reducing the number of BPRs it is not desirable to force LPDs to seek BPR status.

The experience from Indonesia with regulating MFIs under the banking act are mixed and some **lessons** may be drawn:

1. The **BRI Unit Desa**, representing the world's largest MFI network are part of a state commercial bank and have so far not posed any major problems for the regulator since supervision is carried out within the BRI itself through a special division. Cost for supervision thus becomes part of the overall operating costs of the bank and is treated accordingly. The overall ill health of BRI as a commercial bank, however, as raised concerns about the impact on the Unit Desa. So far, no negative impact could be observed and is not anticipated to occur.

2. The regulatory framework of the **BPR** is currently being adjusted and supervision is reviewed. Adapting supervisory tools and practices from commercial banks to this type of microbank has not resulted in guaranteeing a satisfying performance of BPR. Proper supervision of BPRs requires frequent on-site visits (at least 4 - 8 times a year) to undertake detailed portfolio audits, which would overstretch the personnel capacities of the central bank and make BPR supervision prohibitively expensive. Increased self-regulation through the involvement of the BPR association Perbarindo and a private deposit protection scheme is a strategy to overcome these problems.

3. The regulatory framework for nonbank financial institutions of the **LDKP** type delegates certain regulatory and full supervisory functions to the provincial governments and their Regional Development Banks (BPD). The outcome has differed greatly depending on the commitment of the provincial government and the technical capacity vested in the respective BPD.

4. The strategy to graduate **LDKPs** into BPRs is a mixed blessing. It has increased the number of relatively small BPRs to be supervised by Bank Indonesia by another 625 banks (or by 35%) to a total of 2,420. This recent development is obviously in contradiction to BI's current policy of raising entry barriers for new BPR.

5. The **LDKP** as a nonbank financial institution could be an ideal vehicle to establish a rural financial infrastructure in the eastern provinces of Indonesia, where there is hardly any financial infrastructure for the people yet. A special law clarifying the status of deposit taking LDKPs vis a vis the status of a BPR would be helpful to launch such a development. Another alternative would be to amend the banking act by providing a flexible regulatory framework that allows regional governments and their institutions to set up LDKPs by respecting certain given standards and rules.

6. The **LPDs** in Bali are about to strengthen their regulatory and supervisory framework by introducing deposit protection and auditing through the formation of an association. This could be a strategy for other regions to follow, rather than to convert more LDKPs into BPRs.

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10.Annexes

10.1.German Technical Assistance to Microbanking in Indonesia

ProFI

ProMB

PHBK

10.2.Banking Act and BI Regulations