

**Commercialization of Microfinance  
And Linkages  
Between  
Microfinance and Commercial Banking**



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# Commercialization of Microfinance and Linkages Between microfinance and Commercial banking

## A. BACKGROUND

### 1. *The Role of Microfinance.*

Microfinance, defined as financial services for the poor, has become a major issue in developing countries over the last few decades. It is widely believed that a properly designed and implemented microfinance model can do much to alleviate poverty. Since the 1980s, movements to promote microfinance by government, private sectors and NGOs have been initiated in most developing countries; some have been quite successful, while others have not done that well.

One of the contributing factors to the failure in establishing sustainable microfinance is the lack of understanding about the markets, which leads to the use of improper tools, over emphasis on short-term goals, and mixing up political goals with business objectives.

Bank Rakyat Indonesia (BRI), known globally as the most successful practitioner in establishing sustainable microfinance, has undergone bad and good times along with its more than one century experience in providing financial services for the poor. Hopefully, it has meaningful expertise and experience to share.

### 3. *BRI's Microfinance History*

**Prior to 1983:** Government agent of development

Founded in 1895, Bank Rakyat Indonesia (BRI) is the oldest bank in Indonesia. Since the beginning, it has maintained a consistent commitment to agricultural and rural development. As a state-owned bank, BRI has been providing microfinance for more than a century. During this period BRI was basically a government agent of development with a special mission to promote agricultural and rural development. Often this mission was mixed up with the poverty alleviation programs.

BRI microfinance system, known as the *BRI's Unit Desa system*, was established in the early 1970s to channel subsidized government loans to rice farmers through *BIMAS*—the credit component of Indonesia's massive effort to reach national rice self-sufficiency. About 3,600 *Unit Desas* were established nationwide at the sub-district level; these rural bank outlets functioned primarily as channeling agents for BIMAS and other subsidized rural lending programs. Although the goal of rice self-sufficiency was achieved in 1985, the program experienced high level of arrears and losses.

Savings accounts were offered through the system beginning in the mid-1970s. But annual interest rates, set by the government at 12 percent for loans and 15 percent for most deposits, discouraged BRI's units from undertaking active savings mobilization.

Losses mounted, and by 1983 the BRI Unit Desa system had reached a point at which it would have to be either closed or converted into a fundamentally different system.

### **After 1983: Commercial Microfinance**

The milestone of BRI's commercial microfinance was in June 1983, when the Indonesian government announced the first of a series of major financial reforms. The two significant changes in the reforms that affected BRI Unit Desa dramatically were: (1) Termination of *BIMAS* and other government subsidized loans, which had been the only business of BRI Unit Desa. (2) State-owned banks would now be permitted to set their own interest rates on both loans and deposits, and the government would no longer provide them with funding resources.

Among other purposes, this deregulation policy provided an enabling environment for the transformation of BRI Unit Desas into a commercial microfinance system by offering financial services to the poor based on market approach.

In early 1984, the BRI Unit Desa system introduced its new program of general-purpose credit, called *Kredit Umum Pedesaan (KUPeDES)*. This individual loan, up to Rp 50 million (equivalent to ±US\$ 5,800), is made available to creditworthy rural borrowers for all productive purposes. Loan terms are simple and transparent, and typically last 1-3 years with regular installments.

By August 2004 there are more than 3,1 million outstanding borrowers with total loan of Rp17.5 trillion (±US\$ 1,9 billion). The average loan size at disbursement is approximately Rp5.8 million (±US\$ 675), Over the past 12 months, BRI Unit Desas have collected 99.4% of payments fallen due. BRI Unit Desa lending represents around 21% of micro and small credit outstanding in Indonesian commercial banks.

Savings instruments for BRI Unit Desas were introduced almost simultaneously. The most popular rural savings instrument, called *Simpanan Pedesaan (SIMPEDES)*, provides the much-in-demand combination of security, convenience, liquidity, confidentiality, good service, and real return. Equally impressively, BRI Unit Desas have approximately Rp 30 trillion (±US\$ 2.9 billion) in total savings from 30 million savings accounts.

The BRI Unit Desa system has been profitable and independent of subsidy since 1986. In 1996 (before the economic crisis), the return on assets for BRI's micro-banking was 5.7 percent before tax, while the banking industry average in Indonesia for the same year was only 1.5 percent.

Nowadays, the BRI Unit Desa system has 4,047 Unit bank offices and 199 service posts nationwide. Over 80 percent are located in rural areas and small towns. BRI's micro-banking has provided a level of outreach unrivalled by any other financial institution, and has been regarded as the most advanced example of the microfinance revolution<sup>1</sup>.

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<sup>1</sup> Marguerite S. Robinson, *The Microfinance Revolution* Volume 1, p. 58

Beginning in 2002, BRI has launched a new effort to bring information and communication technology (ICT) to its Unit Desa system by developing cost-effective on-line banking services. BRI already put at least 450 of the BRI Unit offices on-line by August 2004.

## **B. BRI's Strategy in Viable Microfinance**

### **1. *Banks follow businesses***

The implementation of supply-leading finance theory, which started in the post World War II era of the late 1940s and the 1950s, has led to the massive subsidized rural credit programs established throughout most of the developing countries. The theory that advocates supplying finance in advance of the demand, suggests that banks or financial institutions take the lead in rural development.

Unfortunately, the facts did not substantiate the theory. By the late 1960s and early 1970s serious difficulties with subsidized rural credit programs had begun to become apparent. By the late 1970s and the 1980s criticisms of the rationale behind those programs filled the development literature. Many governments and donors, however, continued to maintain large subsidized credit programs long after their intrinsic defects were well known, and many of these programs are still continuing today.

In contrast with the supply-leading approach, the market-driven approach assumes that credits will only be helpful if business activities are already in place. Simply put, banks or other financial institutions should follow where the businesses are, not to take the lead as suggested by the supply-leading approach.

### **2. *Credit is not a magic cure***

Credit is no magic cure for poverty. It plays an important role in reducing poverty and promoting economic development, as long as the access to capital is the main constraint facing micro-enterprises. If there are more basic constraints (e.g. skills, knowledge, health, access to market and raw material), other solutions will be in demand.

It has been shown that credit can indeed assist low-income households to move out of poverty and increase their incomes – when the enabling environment is conducive and when the household is already running or participating heavily in an enterprise. In retrospect, this is obvious: when capital is the last scarce factor of production missing for a household, the impact of borrowing can be very high. When households are also missing other factors, such as business experience, secure land tenure, or physical access to markets, credit will not help much.

When it is done properly, providing the poor with consistent and convenient access to financial services can produce significant economic and social benefits: efficiency gains, because micro-enterprises are highly efficient users of capital, and equity gains, because

more enterprises will have the ability to take advantage of existing opportunities. Along the way, a large proportion of the “enterprising poor” will be able to move fairly rapidly out of poverty, with a smaller number advancing much further. The provision of a credit subsidy has proven to be generally unnecessary in Indonesia: what matters is effective access to credit whenever the households need it.

It is also true that credit is not the only financial service needed by low-income households. Convenient access to a safe means of accumulating financial savings is also important, not least because it enables households to build up a financial cushion against business or family difficulties which would otherwise cause them to drop back down into poverty. BRI has shown that even poor households have significant savings potential.

Finally, there has been a more recent addition to the basic “package” of financial services: the ability to send and receive funds quickly, cheaply, and reliably. Exploiting new technology, payments services are for the first time beginning to meet what has in fact been a longstanding need for many low-income households and micro-enterprises.

### **3. *Using the right tools***

Microfinance as a tool for poverty alleviation needs to be understood thoroughly, so does the structure of the poor itself. This understanding shows how to apply the right tool to the right target. Let us begin with the analysis of the poor; technically the poor can be segmented into two groups: (1) the poorest of the poor, and (2) economically active poor.

The first segment consists of those who do not have any capacity at all to generate income due to the lack of skills, education and capital. Obviously this group is hapless, and technically speaking they need help to stay alive. Providing this group with micro-credit will not overcome the problem. They need basic necessities, such as food and shelter, as well as training programs to build their self-confidence and productive capacity.

The second segment refers to the poor who have some sort of productive capacity. They may be running a simple or informal business, or engaging in micro-enterprise. Providing this group with micro-credit will help significantly. They are efficient users of capital because their businesses usually have a high turnover and are insensitive to either interest rates or economic fluctuations. In most cases, however, these micro-entrepreneurs get trapped in credit schemes provided by moneylenders.

Having understood the structure of the poor, then we can apply the right tools to the right targets. Basically, the financial services in microfinance can be divided into two groups as follows:

#### **1. Poverty alleviation programs.**

It is quite obvious that poverty alleviation programs should be aimed to the poorest of the poor. These programs may include social safety nets, such as food and shelter for free, training programs followed by technical assistance, and subsidized-programmed

loans. Commercial banks or financial institutions certainly cannot afford these programs. In fact, it is the government's responsibility to provide these services. It is also the right place for donors and NGOs to participate in. However, such programs should be integrated and continued, with clear targets and time frames. For instance, within 1-2 years the targeted poor must be able to run their own micro-enterprises and, therefore, can be served by commercial microfinance. Otherwise, the poverty alleviation program acts just like aspirin; it kills the pain for a while, but does not cure the real problem.

## 2. Commercial microfinance

The economically active poor are the right market segment for commercial microfinance. Although the overhead costs of serving this market are naturally high, there is a room for establishing sustainable microfinance. Because of its small ticket and high turnover, micro-lending can generally absorb high interest rates. In Indonesia, it has also been proven that micro-borrowers are trustworthy people. In order to manage micro-lending effectively, however, a financial approach alone is not enough. It requires a good understanding of the society being served, especially its culture, values and needs.

Mixing up poverty alleviation programs with commercial microfinance will create some problems, as many evidences have shown.

The first problem occurs when poverty alleviation programs—such as grants or subsidized loans—are targeted at the economically active poor or micro-enterprises already served by commercial microfinance. Such an aiming causes the market mechanism to deteriorate, creates moral hazard, and wastes limited resources. Unfortunately, in order to speed up economic development, this mistake happens over and over again.

The second problem arises if commercial banks or microfinance institutions are forced to take care of the poor. As a state-owned commercial bank, BRI faces this dilemma quite so often. To overcome the problem, we handle the poverty alleviation programs by developing an organizational unit, called *Programmed Loan Division*, which is separated from BRI Unit system. One of those programs, which has been quite successful, is “P4K” (Income generating project for small farmers and landless). In addition, we also supervise and nurture some 5,000 BKDs, a village banking system which is run by government administration at the village level.

## C. KEY SUCCESS FACTORS

Looking back to our experience in transforming the *BRI Unit Desa*, from a subsidized system into a self-sufficient and sustainable microfinance, we believe that the following factors have been contributing to the success:

### ***1. Constant Focus on Sustainability***

Obviously, for a microfinance business to be sustainable, it has to be able to earn enough margins to cover all of the business costs, including the cost of money, overhead costs, and the cost of the loan reserve. This requires a careful pricing policy in micro-lending. The interest rate for loans should be set in such a way that it covers all the costs and is still affordable by micro-enterprises. Unfortunately, micro-lending, by its nature has to bear a higher interest rate for two reasons: (1) high overhead costs, and (2) high risk

In addition, micro-lending has to be managed prudentially. Although conventional standards in lending procedures may not be applied rigidly, it is critical for the lenders to make sure that the borrowers will pay back any loan granted. This requires not only a good understanding of micro-credit analysis, but also a good monitoring system that enables the lenders to take appropriate measures if the problem loans grow beyond acceptable standards.

Last but not least requirement for sustainability is financial self-sufficiency. To be sustainable, a microfinance institution must have enough sources of funding for the asset side of its balance sheet. Otherwise, credit activities will continuously depend on the source of funds from donors or government. At BRI, that micro-savings and micro-credits are equally important is a basic tenet of our microfinance system. Through extensive micro-saving mobilization programs within the rural community, we have captured sufficient funds to serve broad outreach with a continuously growth rate. Our experience has also shown that poor people have the ability and the need to save.

### ***2. Simplicity***

Financial services for the poor should be simple enough to understand. We apply this simplicity principle in all aspects of our operations, including product design, systems and procedures, forms, requirements and reporting. Considering the characteristics of our clients– some of them are even illiterate—we provide simple products and services that can be easily communicated to any level of society.

### ***3. Transparency***

Transparency requires active supervision at all levels. Our financial transparency is based on a strict, rule-based loan classification system and income statements at all organization level. Accurate and transparent financial statements can in turn become the basis for management supervision; star performers are recognized and rewarded, while corruption or negligence results in sanctions or firing. In addition to tracking performance through clear and timely management reports, we also place a strong emphasis on on-site supervision. First line supervisors are placed to make sure that all aspect of the bank's operations complies with the standard operating procedure.

### ***4. Prudential banking practices.***

According to conventional banking standards, poor people are mostly not bankable. To make it work, microfinance needs a multi-dimensional approach; including sociological and cultural approaches – using the financial approach alone is not enough. However,

prudential banking practices are still the key success factor in establishing sustainable microfinance. Although it sounds a little complex, in reality, the bottom line is very simple, i.e., lenders have to make sure that borrowers have a sufficient repayment capacity. BRI's experience has shown that micro-credit is not a high risk investment as it was superficially perceived to be. In fact, the repayment quality of BRI's micro-credits has never been below 95 percent, even during the period of economic downturn. Since the beginning, the average loan quality has been about 98 percent, which is much better than those of corporate and retail lending.

## **5. *Accessibility***

Providing the poor with extensive and easy access to financial services is equally crucial in promoting microfinance. In order to reach as many poor as possible, a large number of outlets are needed. Needless to say, it requires a huge amount of capital expenditures, which not many microfinance institutions can afford. In retrospect, we were thankful for the availability of some 3,600 Unit Desa offices left by the BIMAS program in 1983.

## **D. FUTURE CHALLENGE**

### **1. *Establishing a linkage between the big and the small.***

One of the ever-tempting challenges in promoting micro-enterprises is to establish a linkage between micro-enterprises and big corporations on a win-win basis. It is tempting from the political, social and economic points of views. Certainly, large, wealthy corporations will not feel comfortable or safe if the surrounding community is poor people. In contrast, growing micro-enterprises can provide big corporations with efficient inputs, as well as potential buyers for their products.

### **2. *Extending outreach.***

Generally, poor people have no access to financial services due to the problem of distance. They are reluctant to go the bank because of their limited knowledge and ability to bear transportation costs. Therefore, to extend outreach, micro-financial services should be made available as close as possible, everywhere the poor are located. This requires a large number of microfinance outlets, which in turn requires huge amount of capital expenditure. Unfortunately, most microfinance institutions have very limited financial resources to explore such opportunities. This is the place where governments and donors should participate in promoting microfinance.

### **3. *Bringing information and communication technology (ICT) to Micro-finance.***

Another constraint faced by micro-enterprises is the lack of information about markets, prices and production technologies. If the information technology can be made available for them through an efficient and easily accessed media, we can expect more micro-enterprises to grow. This may sound very futuristic; indeed, e-commerce is not an impossible thing for micro-enterprises. It is just a question of when!

## **E. BRI's COMMITMENT TO DEVELOPING MICROFINANCE**

As a reflection of our commitment to promote sustainable microfinance around the world, we have established the *International Visitor Program*—a program sponsored by USAID and CGAP with a mission to share BRI's expertise and experience through training programs, study visit, seminar and workshop, comparative studies, research, and consulting. Since its inception in 1996, more than 1,800 visitors from all over the world (50 countries) have joined the program and replicated the *BRI Unit Desa* system in their home countries. Those visitors consist of policy makers, microfinance practitioners, researchers, government officers and donors.

