

# SPEAKER NOTE

The Future of Microfinance in Indonesia

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## FUTURE OF MICROFINANCE IN INDONESIA

First of all, I really honored to be part of this important conference, Moreover, I want to thank the organizers and acknowledge Banking With The Poor for its roles and contributions in strengthening microfinance in Asia.

Ladies and gentlemen, I received an invitation from Banking With The Poor to speak about the future of microfinance in Asia. Frankly speaking, it is not easy to predict what will happen in the region which is developing so fast and dynamic, therefore I would discuss some critical issues of microfinance in the perspective of Indonesia, but those topics are still relevant to the Asian context. This presentation is divided into 3 main sections that address the initial history of microfinance, reviewing stages of its evolution, highlighting the main attributes of each stage including exploring the future of the industry.

The early development of microfinance in Indonesia was in the 19th century, when Raden Aria Wirjaatmadja – the founding father of Bank Rakyat Indonesia – established *De Poerwokertosche Hulp en Spaarbank der Inlandsche Hoofden* (People Credit Bank) in 1985. In short periods, this institution became popular among the communities particularly in helping indigenous people lifted out from money lender trap. Other corner stones were the establishment of Paddy Bank (Lumbung Desa) & Village Bank (Badan Kredit Desa) across Java & Madura islands and Pawnshop (Pegadaian).

After independent, the new era of microfinance was in 1970s when the government introduced Rice Self Sufficiency Program (BIMAS) to overcome hunger, mal nutrition and chronic poverty. To support the national agenda, the Ministry of Finance pointed BRI to establish 3600 BRI Unit Desa offices (the initial name of BRI-Unit). The BRI-Unit majority operated in the rural area of major islands such as Java, Sumatra and Bali. The core function of BRI-Unit was to channel subsidized loans to peasant farmers who participated in BIMAS, therefore the operation of BRI-Unit system was supported and controlled by the government. In short, I identify major attributes of microfinance in 1970s such as:

- Microfinance landscape was dominated by BRI-Unit. Other institutions such as government pawnshop, people credit banks, village banks operated in limited capacity & coverage
- Financing approach was supply leading which the government provided subsidized loan, controlled credit ceiling and interest rate

- In addition to loan to rice farmers, there were subsidized loans such as small investment loan and working capital loan (KIK/KMKP) for native Indonesia entrepreneurs which channeled by state-owned banks
- Source of funding solely provided by the government that gained substantial oil revenues and financing from international donors mainly World Bank and FAO.
- For the efforts and achievement Indonesia was awarded by FAO as a Rice Self Sufficient country

In the period of 1980s - 1990s, microfinance changed significantly. The shifting was triggered by sharp declining of BRI-Unit performance in early 1980 which accounted massive losses and very high non performing loans. Recognizing the BIMAS program as a failure, the government exercised the options whether to close the operation of BRI-Units or to continue with different approach. Moreover, in 1983 government simultaneously transformed the banking system through releasing credit ceiling, removing control on interest rate on loans and deposits, and promoting public saving mobilization. Subsequently, the new policies have allowed BRI to transform the BRI-Unit system into commercial practice, provides innovate products and services. In addition, Bank Indonesia (the Central Bank) introduced a new system of rural financial system through revitalizing People Credit Bank (BPR) and Village Credit Body (BKD)

Ladies and gentlemen, during this period the financial sector grew rapidly after the government introduced sequential banking deregulation such as PAKTO 1988 and the Banking Law 1992. In microfinance sector, for example, the number and business volume of BPR increased sharply. I also recognize numerous microfinance programs were developed particularly by local government such as District Credit Body (BKK), Saving & Credit Institution (LPD), Saving & Credit Unit (USP) etc. Those microfinance institutions were designed inherent with poverty alleviation & microenterprise development programs. Moreover, after the economic crisis, the presence of microfinance sector particularly initiated by NGO was stronger to respond the needs of poor households & microenterprises on microcredit and alternative financing scheme (profit & risk sharing under Islamic practice) provided by Baitul Mal Tamwil (BMT), Shariah microfinance institution.

In general, I find out some key issues which highlight this era:

- There was a shifting from supply leading and subsidized programs to demand driven & commercial microfinance approach. However, subsidy-based practices were exist mostly tied to poverty reduction and agricultural sector.

- Competition among microfinance providers was loose where the presence BRI-Unit dominated the market
- Public saving & deposit gradually replaced subsidized funds as the sources of lending
- Economic crisis affected the performance of BRI which many BPR were seized & closed due to very high bad debt. Most of BPR failed to provide provision for loan losses and insufficient capital to cover the losses
- A new government-owned has been created (namely PT. Permodalan Madani/PNM) to support microfinance institutions but its role relatively limited

Now I let's look current stage. I believe that no one will argue that microfinance has been an emerging industry. We are witnessing microfinance is widely accepted by public and private sector. At the one end, the industry is viewed as an effective tool to help low income people getting access financial services. From this view, microfinance role is to substitute the absence of conventional banking system which more desire to serve "bankable customers". On the other end, microfinance is a business like generates profits if the institutional structure, products and services and its operation are properly organized. In this pinpoint, commercial microfinance is not against the essence of helping poor people to escape from poverty prison. I quote a study conducted by Asian Development Study (ADB), which shows commercialization of microfinance in Indonesia is moving forward in term of scale, outreach and sustainability.

Ladies & gentlemen, recent landscape of microfinance in our country is look like a pyramid where the formal institutions such as commercial banks, BPR, & state-owned pawnshop lay at the bottom the structure in term of business volume, networks and number of clients. While semiformal microfinance such as BKD, LPD, BKK & LDKP relatively stagnant due to unclear regulation, limited capital, lack of human resources and bad governance. Informal microfinance such BMT, NGO, ROSCA, money lender etc are still exist in the communities through providing traditional financing mechanism. BMT uses Islamic financing model & in many cases, NGO use integrated approach (microcredit and social intermediation). Obviously, the landscape creates tight competition particularly in urban area where leading commercial banks such as BRI-Unit, Bank Mandiri (the biggest bank in the country) & Bank Danamon (a foreign owned bank), BPD exist. However, in sub-urban and sub-district, BRI-Unit remains the market leader.

Specifically, key findings are driving the present microfinance industry are:

- BRI-Unit, Bank Mandiri, Danamon Simpan Pinjam (DSP) employ downscaling model by establishing semi-autonomous microbanking units.
- Bank Indonesia have promoted a linkage program between commercial banks and BPR. The initiative is to support funding of BPR. In addition the central bank has initiated the establishment of Apex Institution for BPR.
- The government has been established Deposit Guarantee Institution which insures public deposit including BPR. This initiative will increase public confidence on BPR system, in turn will strengthen their funding structure
- A significant progress in the deployment of information technology (IT) to enhance online system, ATM and MIS. Some products & services have been link to IT, i.e. ATM card
- The role of government in promoting microfinance sector is still on debate. The issues of discussion is hot to bring the government as a regulator and facilitator including to provide infrastructures and financial access for the poorest of the poor.

Ladies and gentlemen, now allow me to move one step ahead discussing the future of microfinance. First, I would draw attention on latest information regarding poverty and informal sector which interrelated each other.

- There are 36.1 million people (16.6%) who are living below the poverty line. In addition, the number of citizens who earn income less than US\$ 2/day approximately 100 million. Largest part of them are involving in informal sector.
- Statistic shows more than 40 million Micro & Small Enterprises (MSE) in Indonesia economy system. Approximately 10% of those are served by formal microfinance (bank & BPR). Majority of microentrepreneurs familiar with semi-formal & informal microfinance
- The major constraints of MSE to access formal financing scheme are lack of formal licenses, financial statement, business plan, adequate & marketable collateral, sharing of capital etc.
- Character of business such as seasonal based production (agriculture sector), geographic condition (remote & scatter), lack of infrastructure weaken the attractiveness of microenterprise sector therefore formal institutions are reluctant to serve the segment
- Those constraints have created Iceberg Phenomena which only bankable clients can access the financing scheme, on the other hand, viable & prospective clients (but unbankable) are unable to access sustainable financing resources.

In my perspective, microfinance can be a solution although it is not a magic bullet to solve all the problems. In other words, I believe microfinance is an essential element for Indonesia also other developing countries in reducing poverty and enhance economic development.

Ladies & gentlemen, I would share my opinions and address several interesting issues that will shape the future microfinance.

- The domain of government focus on creating conducive business environment, adequate legal framework (regulation and supervision), institutional & capacity building in order to establish a sustainable microfinance industry. The government must insure the interest of all stakeholders are properly protected, through setting an equal level of playing field, incentive & punishment system, customer protection etc
- Commercialization of microfinance should move forward since the market mechanism has created positive impacts to the industry financial system and the whole economy. The impact of commercialization will bring commercial banks to penetrate the market, in turn, competition will increase. Another positive impact is more new comers will create opportunity to poor clients having access to financial services
- There will be explosive growth in new products and in use of technology. Credit cards, smart cards and others will be added to products. Technology will make the administrative work of the loan officers more efficient, lower costs & convenient
- Microfinance network will increase and attach to the financial mainstream such as money market & capital market. Global funds & investors will aggressively look for emerging investment in microfinance

In short, the progress of microfinance industry can be illustrated like a snowball which revolve to become bigger and bigger in term of business volume, outreach and impact.

Thank you for your attention.