An Overview of Microfinance Linkages in Indonesia*

By John Conroy and Iketut Budastra

ASIA

INDONESIA

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List of Acronyms

ASKRINDO  State credit insurance agency
BI  Bank Indonesia (the central bank)
BMT  Islamic self-help group
BKD  Badan Kredit Desa (Village Credit Board)
BKK  Badan Kredit Kecamatan (Subdistrict Credit Board)
BK3I  Indonesian Cooperative Credit Coordinating Board
BPD  Bank Pembangunan Daerah (Provincial Development Bank)
BPD  Badan Pemerintah Desa (Village government body)
BPR  Bank Perkreditan Rakyat (People’s Credit Bank, ‘Rural’ Bank)
BRI  Bank Rakyat Indonesia (Indonesian People’s Bank)
CRS  Catholic Relief Services
DABANAS  National Private Commercial Bank Foundation
DFI  Development Financing Institution
GOI  Government of Indonesia
GTZ  German bilateral aid agency
IDT  ‘Backward’ villages program
IMF  International Monetary Fund
IKSP  Secondary level savings and credit cooperative
KSP  Savings and credit cooperative
KSU  General purpose cooperative
KUD  Village Cooperative Unit
KUK  Credit for small enterprise
LDKP  Village credit fund institution
LPD  Village Credit institution (Bali)
MFI  Microfinance institution
PERBARINDO  Association of Indonesian Rural Banks
PHBK  Program linking banks with self-help groups
P4K  Income-generating project for marginal farmers and the landless
ROSCA  Rotating savings and credit association
SHG  Self-help group
SME  Small and medium enterprise
USP  Cooperative savings and credit unit
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INDONESIA: A COUNTRY REVIEW

This is an overview study of linkages in Indonesia. It provides a general descriptive mapping of different linkage models that exist in Indonesia. It also refers to the study on the linkage between the provincial government bank in the Indonesian province of Bali (BPD) and the Balinese LPDs, a set of small local non-bank financial institutions, which will be presented as a separate case study.

1. Macroeconomic conditions

During a thirty year period from the end of the Sukarno period to the mid-1990s, the ‘New Order’ government of President Suharto (1967-1998) achieved average economic growth rates of 6 percent annually, while the proportion of population in poverty fell from over 70 percent to well below 20 percent. Two pieces of good fortune assisted in this achievement. One was the ‘Green Revolution’ which allowed Indonesia to achieve self-sufficiency in rice at higher levels of per capita consumption. The other was the oil boom of the 1970s, whose proceeds were used rather more prudently by Indonesia (notwithstanding some notable abuses) than by most other OPEC countries.

Economic management was generally good, combining prudent macroeconomic policies for most of this period with successive sectoral reforms. These included banking deregulation, discussed below, and capital market opening, as well as liberalized trade and taxation reform. Reform facilitated direct foreign investment, employment creation and poverty reduction. This outward-looking policy stance was accompanied by wide-ranging improvements in social indicators, despite which political pressure for the reduction of regional and ethnic income disparities mounted during the latter years of the New Order.

As elsewhere, however, financial liberalization occurring without adequate institutionalization of prudential norms and supervisory capacity, in a political culture of corruption and rent-seeking, left the banking sector vulnerable to external shocks. From mid-1997, the impact of the Asian financial crisis on Indonesia (known as the Krismon, or monetary crisis) proved to be devastating. Real GDP fell by some 14 percent in 1998-99 at the height of the crisis, while inflation (which in general had averaged less than 10 percent annually) rose to 75 percent. The incidence of poverty, which on some estimates had fallen to 12 percent by 1996 increased to perhaps 27 percent by early 1999. Details on the impact on the commercial banking system is provided in the section on institutional development, but in general the krismon caused widespread bank failures, and necessitated a painful and protracted process of consolidating and reconstructing the sector. Those regulated banks and non-banks more exposed to microfinance lending fared substantially better than the commercial banking system as a whole, a finding also discussed below.

By late 2004, at the time of this study, Indonesia had chosen Bambang Susilo Yudhoyono as its first popularly elected president. The economy returned to growth, with real annual GDP growth increasing from 4 to 5 percent since 2000, and Indonesia was exiting from
the IMF programme imposed upon it. Inflation had declined to a manageable 6-7 percent, while yields on government bonds ranged from 8 percent (one year) to 10 percent at the longer end, and were declining. Corporate debt restructuring and bank reorganizations had increased the availability of and demand for credit in the corporate sector, while real commercial lending rates had declined from about 20 percent at the start of 2000 to about 7-8 percent by mid-‘04. The overall incidence of poverty had returned to around the 1996 level. However the tsunami of December 2004 was a severe blow and will impose substantial reconstruction costs. The disaster also threatened to divert attention from further administrative and structural reforms, needed to achieve higher growth rates and faster employment creation and poverty reduction.

2. Agricultural and rural development strategies

At the commencement of Suharto’s New Order, from the mid-1960s, Indonesia depended on imports and ODA to meet the aggregate food needs of its population. For this reason, food self-sufficiency, especially in rice production, was the cornerstone of New Order agricultural policy. The early, unprofitable, history of BRI’s ‘Village Units’ is closely related to efforts to achieve food self-sufficiency. Before a drastic policy shift within BRI, from 1983 (described below), the Units channeled subsidized credit to farmers, incurring heavy losses. Credit from official village cooperatives was central to these agricultural policies, and also supported the system of patronage employed to maintain political control.

Nonetheless, agricultural policy enjoyed considerable success, with rapid output increases for crops and animal products. Annual real agricultural sector growth averaged close to 4 percent over the period 1968-1992, bringing higher rural incomes and improved nutrition standards. A slowdown towards the end of this period was succeeded by stagnation during the 1990s, with growth measured at less than 1 percent annually. A new problem for the agricultural sector, with increased import liberalization, is the competition of cheaper farm products, mostly from China and Thailand. In reaction, there is the hint of a possible return to New Order policies of self-sufficiency in key food crops, supported by ‘incentives’ and import quotas. These might be difficult to reconcile with Indonesian obligations under regional and bilateral trade agreements and with its aspirations for the Doha round of trade negotiations.

The character of Indonesia’s rural sector has implications for the demand for financial services. Agriculture is the source of only half of rural household income, with the balance from rural non-agricultural activities and the earnings of circular migrants. The agricultural sector still provides 45 percent of employment and contributes 17.5 percent of GDP. Rural households typically have multiple sources of income, including informal sector activities (food processing, and petty trading, services and manufactures) and remittances. This diversification of the rural economy is more pronounced on the more populous islands, including Java. In turn, this diversification is reflected in the greater range and variety of financial institutions in Java and some other areas, and in the range and volume of financial services demanded by these rural populations.
3. Financial sector development strategies

A number of phases of financial sector development can be defined. These include, firstly, the period of the ‘New Order’ government, following the downfall of Indonesia’s founding president, Sukarno. This long period commenced with the stabilization of the Indonesian financial sector after the economic chaos of the late Sukarno period, the entrenchment of various elements of financial repression by the New Order, and then successive phases of financial liberalization from 1983, commencing with the freeing of interest rates in the banking sector.

A second phase commenced with the end of the New Order regime, which was precipitated by the Asian economic crisis from mid-1997. From 1998 to 2004, prior to the election of President Susilo Bambang Yudhoyono, Indonesia had three successive administrations, those of Presidents Habibie, Abdurrahman Wahid and Megawati Sukarnoputri. Throughout this period Indonesia’s economy remained under the tutelage of the IMF and the desperate condition of the national banking system forced drastic changes to the financial sector. On the other hand, and to the credit of the deposed New Order government, Indonesia had developed a range of microfinance institutions that coped surprisingly well with the financial shocks of the Asian crisis.

The economic and political events described above had considerable implications for the Indonesian financial sector, and for its capacity to provide financial services for the rural poor. The chronology as presented will give particular prominence to the role of the central bank, Bank Indonesia. The full set of microfinance linkages in Indonesia is presented in Figure 1 on page 7.

The reason for putting the central bank at the centre of the narrative is that it has assumed an uncommonly important role in relation to microfinance. This is because of the dominance of the rural- and micro-finance sector in Indonesia by regulated financial institutions. Bank Indonesia (BI) has regulatory oversight of most of the major institutions engaged in microfinance and has participated actively in shaping them. Some account of BI’s evolution as a central bank is necessary to explain the circumstances which led Indonesia to develop a set of formal financial institutions capable of providing microfinance services and employing linkages for that purpose. It is also relevant that BI has since the late 1980s supported linkages between financial institutions as a strategy for the provision of rural- and micro-financial services to poor and low-income people. This strategy has recently gained fresh momentum as an element in Indonesia’s planned new national ‘Banking Architecture’, discussed below.

Following the downfall of President Sukarno, and the emergence of Suharto’s New Order government, a central bank law was enacted in 1968. This gave Bank Indonesia a strong ‘developmental’ mandate. However, in 1983 a contrary process of financial sector deregulation and liberalisation commenced. One consequence of this process was the successful turnaround of the village-level financial operations of Bank Rakyat Indonesia (now Bank BRI), the state bank whose primary focus was the agricultural sector. A further financial deregulation ‘package’ in 1988 continued the liberalisation process.
Among other measures, it freed-up entry of new banks to the so-called ‘rural bank’, or BPR, sector. These institutions are also discussed below.

Commencing in 1990, the Government committed to rolling back the system by which it had required BI to provide rediscount facilities (known as ‘liquidity credits’) to finance the needs of ‘priority sectors’. These subsidised credits were associated with gross resource misallocation and misuse (although it is also fair to say that they provided some of the earliest experience of financial linkages). After 1990 the scope of liquidity credits administered by BI was restricted. Since 1999 BI has vacated the field, due to changes in its legislation and mandate, described below. A long ‘tail’ of liquidity credits still circulating within the banking system is now administered according to different principles by a number of ‘apex’ institutions, also described below (see text box 1). In addition, there still exists a multiplicity of credit schemes administered by line agencies of government, of a social safety-net or sectoral character and with varying degrees of subsidy, that channel funds via provincial government agencies, banks, cooperatives and NGOs. Together with the liquidity credits these schemes disburse more than a billion dollars annually.

Under Suharto’s immediate successor, President Habibie, a new central banking law was enacted in 1999. Designed to secure greater independence for Bank Indonesia, the Act also reduced BI’s mandate to the single objective of maintaining the stability of the rupiah, both internally and externally. BI’s previous role as an ‘agent of development’, by which it was responsible for channelling credit to priority sectors and social groups was abolished. These credit functions were transferred to specialized apex entities. The continuation of credit subsidies thus transferred was to be time-bound, and their costs were to be approved as part of the government budgetary process, rather than being funded off-budget by BI (see section 4 and text box 1).
Madani is executing agency for former BI liquidity credits. Mandiri is a state commercial bank. Both active in linkages. DABANAS is a foundation created by private commercial banks to channel working capital credits to BPRs.
BI’s function as the prudential supervisor of banks was to be surrendered by the end of 2002 to a new institution to be created for the purpose. However, BI was to retain the role of bank regulator. During the subsequent presidencies of Abdurrahman Wahid and Megawati, political and bureaucratic manoeuvring contributed to delaying these changes. Some support for reviving the role of BI as an ‘agent of development’ was evident, together with calls for the restoration of liquidity financing. Nonetheless, a ‘Letter of Intent’ transmitted by the Government to the IMF in August 2001 committed the GOI to maintaining a ‘strong, independent and accountable central bank’ and to amending the BI Act. The Government’s intention was said to be to ‘preserve [the Bank’s] independence while increasing its accountability’.

**Text box 1: Bank Indonesia, ‘liquidity credits’ and PN Madani**

Central bank subsidized credit; (KLBI or *Kredit Likuiditas Bank Indonesia*) was a policy and political instrument of the ‘New Order’ government of President Suharto (1967-1998). These credits were tools of agricultural policy to secure national rice self-sufficiency, and instruments of income redistribution to support SMEs against the perceived power of big business. But beyond this they were used to support a wide range of economic objectives. As a tool of political control these credits were distributed so as to bestow rents, through mistargeting and misappropriation, upon functionaries and supporters of the government at every level down to the village. The primary instrument for achieving agricultural policy goals and distributing political patronage was the KUD, the officially-sanctioned Village Cooperative Unit. State banks, including the retail branches of BRI, also acted as channels for cheap credits.

Continuing the financial sector liberalization process of the 1980s, a reform in 1990 reduced some of BI’s subsidized credit programs and halted others. Of those remaining, credits for food self sufficiency, SMEs and cooperatives are of primary interest for the purposes of this study. Such credits continued to be made available to channeling institutions by BI for fixed terms, during which they were to be circulated to finance economic activities consistent with government policy. Thus, at the commencement of the crisis in mid-1997 a considerable volume of BI credit was still held on the balance sheets of channeling banks. With the economic downturn, and as NPLs mounted, the banks’ capacity to recover payments and meet obligations to BI was severely affected.

Coincidentally, during the crisis there was a resurgence of subsidized lending for ‘social safety net’ purposes. Much of this was channeled via the KUD system, with predictable wastage and misappropriation. Also, the central bank advanced emergency credits of Rp179 trillion\(^1\) during 1997-98 (the infamous BLBI, or *Bank Likuiditas Bank Indonesia*) to distressed banks, most of them politically well-connected. Loans to these banks have proved difficult to recover. These two episodes and their subsequent handling are issues quite separate from the KLBI and from the reform government’s attempt to put state credit programs on a more transparent and accountable basis as part of the central bank reform process, described below.

With the new central banking law, enacted in 1999, BI’s role as an ‘agent of development’ was abolished. The government issued debt (*Surat Utang Pemerintah*, or SUP) to compensate Bank Indonesia for outstanding liquidity credits and transferred responsibility for their further management to state-owned enterprises (including PN Madani, Bank Mandiri and the state-owned pawnshops (*Pegadaian*). These entities were to be responsible for securing repayment of

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\(^1\) Perhaps $14 billion, though this is difficult to calculate in a period of extreme exchange rate instability.
credits held by channeling banks and for recirculating them, for purposes set by government, until their expiry dates. Credit subsidies were to continue, but to be time-bound, while their costs were to be taken into the national budget, rather than being funded off-budget by BI as in the past. These procedures can be seen as an attempt to wind down the provision of credits for policy lending while dealing with the outstanding debts of the banking system to the central bank, as well as bringing the subsidy costs of policy lending out into the open. One particular debt issue, amounting to Rp 3.1 trillion and with a currency to 2009, was designated specifically for micro- and SME lending. Disbursement of this ‘SUP 005’ funding has been slow while the necessary process of strengthening BPRs and KSPs to act as intermediaries is continuing.

Amending legislation, which finally gained approval in December 2003, essentially delivered on that commitment. Further, the policy of phasing out government ‘liquidity’ credits and removing them from BI’s control remained in place. A lender of last resort facility was established for the central bank, funded by government debt but designed to be aloof from political influence. The blanket guarantee on banking system deposits put in place during the crisis was to be replaced by a regular deposit guarantee system. Efforts at financial sector reform in Indonesia, whether in commercial banking, central banking, or in the microfinance sub-sector, invariably encounter resistance from entrenched interests. The transfer of BI’s bank supervisory functions to a new entity has been postponed, apparently until 2010, while the drafting of legislation on microfinance regulation and supervision has proved a painfully slow process (see discussion below, this section).

BI’s surrender of that part of its liquidity credit financing function designed to support micro, small and medium enterprise and the cooperative sector was partly accomplished by creating a new ‘apex’ institution in 1999 - PT Perusahaan Nasional Madani (PN Madani), a state-owned enterprise. PN Madani was created to support government policy objectives through targeted lending, but on an accountable and sustainable basis by comparison with the liquidity financing practices of the New Order. PN Madani is discussed in some detail under below. In addition, Bank Mandiri, a new state bank formed by amalgamating and restructuring four failed state banks, has been tasked with some apex lending functions, discussed below.

Another policy direction of particular relevance to linkages is the new ‘Banking Architecture’ announced in 2003. Bank Indonesia is determined to create a banking system to repair the systemic and structural weaknesses revealed by the Asian financial crisis. It recognizes the rural- and micro-banking role of a particular banking model, the Bank Perkreditan Rakyat (BPRs or ‘rural banks’, described below), and the BPRs will serve as an ‘under-story’ for the tall timber of the commercial banking system, providing formal financial services for micro- and small business and the rural informal economy. The commercial banks will be encouraged to nurture linkage relationships with BPRs. It is expected that increased competitiveness of rural banks will result from such linkages. The regulator will make it easier for well-performing rural banks to expand branch networks, and will encourage the establishment of joint ‘back office’ facilities for BPRs.

The new architecture is to include a ‘credit guarantee scheme’, referred to also as a ‘credit insurance agency’. This is seen as improving the access to credit of social groups
normally deemed unbankable. It appears to be intended to benefit micro-, small and medium entrepreneurs and may take the form of strengthening an existing state insurance agency, ASKRINDO. While this would enable banks, including BPRs, to insure against default on micro-lending, it is difficult to imagine such a measure would have no moral hazard implications. Bank Indonesia is also exercising moral suasion towards commercial banks to encourage them to draft business plans in which targets for micro- and small lending are set. Certain private banks have arranged to direct money towards such lending by passing funds through a foundation, DABA NAS, set up by the peak body of Indonesian private banks, PERBANAS. This is, in effect a private apex institution.

Commencing 2001 efforts towards a new microfinance law has been taken. Proponents of such a law point to the deposit-taking activities of a range of entities other than regulated banks or cooperatives. These latter institutions are legally entitled to accept deposits under their respective Acts, but no such provision exists for the former set of institutions. These other entities (which are discussed in the next section of this study) are thought to require a regulatory and supervisory environment designed to protect their depositors from loss. In the current phase of Indonesian political history, which is dominated by the devolution of government functions, suggestions for recentralization are difficult to sustain. Also, discussion of proposals for a microfinance law tend to expose a continuing dichotomy between a ‘new paradigm’ of financial intermediation and sustainability and an old, but still active, paradigm of subsidized credit for priority sectors, supported by bureaucratic and rent-seeking interests. Suffice to say that no national law acceptable to these contending interests had been presented to the legislature at the time of writing. Discussion of amendments to cooperative legislation had been proceeding in parallel with that for microfinance. This appeared to have increased the difficulty of resolving the issues.

4. The institutional landscape of rural- and micro-finance

The financial crisis from 1997 revealed that Indonesia had developed a set of rural- and micro-finance institutions that proved to be more robust than the formal financial institutions serving the corporate and urban sectors. These will be considered in the context of the institutional landscape of the rural- and micro-finance sector, with particular reference to linkages, actual or potential, between institutions.

The Banking System

This section describes the commercial banks and the BPRs, or ‘rural banks’. Among commercial banks are the Regional Development Banks (BPDs), which are of great significance for linkages. Other categories of BPRs, often tied into linkages with larger entities are also considered. The study will give relatively little attention to the famed ‘Unit’ system of Bank BRI because the Units do not become involved in linkages. It may be useful to speculate why this is so.

Commercial Banks

The legislation governing the banking system in Indonesia (the Banking Act of 1992 and amending legislation of 1998) provides for two kinds of banks. These are the commercial
banks and the BPRs (Bank Perkreditan Rakyat, literally, people’s credit banks or ‘rural banks’). The Indonesian commercial banking system was devastated by the Asian financial crisis. Both state and private commercial banks were saddled with huge non-performing loans, estimated overall at 60 per cent at the highest point, leading to numerous closures, mergers and restructures. Starting with some 237 commercial banks in 1997, the sector contained only 138 institutions by the end of 2003. The largest state commercial bank is now Bank Mandiri, an amalgamation of several failed state banks. It is discussed here as a significant initiator of linkages with BPRs, consistent with the vision of a new ‘banking architecture’ for Indonesia.

Commercial banks had limited involvement in microfinancing prior to the crisis. However, under the New Order, a number of commercial banks were involved as channeling agencies in official credit schemes implemented by Bank Indonesia for SMEs and the members of state-sanctioned village cooperatives. The banks involved were mostly state banks but included some smaller private banks. Programs such as the mass provision of subsidized central bank ‘liquidity credits’ to SMEs and rural cooperatives and the KUK (small scale business credit which was designed to direct 20 percent of commercial bank lending to the ‘small’ enterprise subsector), involved little genuine microcredit. While these programs were ill-targeted and yielded massive rents to the politically well-connected, their closure or diminution has nonetheless left a gap in the rural financing infrastructure.

A number of commercial banks were involved in another government microfinance programme, the PHBK (Program linking Banks with Self-Help Groups). This was a pioneer linkage program and it and its successor activities are examined in this study (text box 3). Also, prior to the crisis some larger private commercial banks had begun to explore the market potential of lower-end financial services, by linkages with, and the acquisition of, small banks (BPRs). This was done to discharge their small business lending obligations under the KUK regulations, mentioned in the previous paragraph. But these moves also reflected a longer-term strategy to explore non-metropolitan markets for their savings potential. The financial crisis stopped to this tentative expansion of services to low-income people. However, several small private commercial banks also developed niche activities in microfinance and one of these (Bank Dagang Bali) had acquired an international reputation for its microfinancing innovations.

Regional development banks (BPDs)
The Indonesian BPDs (Regional Development Banks), one in each province, is of particular significance to linkages. They are owned by the provincial governments, and act as bankers to their governments, and support them in provincial development. The BPDs also perform some apex functions when the BPDs act as wholesalers to convey loanable funds from governments and donors to smaller linked financial institutions. Some BPDs also have responsibility for supervision of certain small formal financial institutions operating within their provinces because these institutions (known collectively as the LDKPs) operate under provincial regulations. These apex and supervisory responsibilities appear to be increasing, due to recent governmental

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2 This bank failed in 2004, but for reasons having nothing to do with its exposure to microfinance lending.
devolution. Newly-empowered local governments are seeking solutions to problems of access to rural financial services, and are involving their BPDs in the process. This issue is discussed below.

**Bank Rakyat Indonesia**

Bank Rakyat Indonesia, (now known as ‘Bank BRI’) is one of the largest commercial banks in Indonesia. Its structure includes corporate, retail and ‘microbanking’ divisions. Unlike a number of other state banks, BRI survived the crisis without being rolled into an amalgamated entity. Bank BRI’s microfinance activities are conducted by its microbanking division which operates village-level outlets known as ‘Units’ (formerly ‘Unit Desa’ or ‘village units’). The individual BRI Units are administered from BRI’s retail branches in rural areas, but are distinct profit centres with their own staff, separate from both the retail and corporate divisions of BRI, and quarantined from participation in any form of ‘program credit’. This policy dates from the bank’s decision to discontinue the Units’ channeling role for subsidized agricultural credits in 1983. With a philosophy that might well be described as ‘keep it simple, keep it focused’; Bank BRI management has continued to eschew any linkages between the Units and other financial institutions. This policy contrasts with the continuing involvement of BRI’s retail branches in such activities.

Bank BRI’s Unit system performed strongly throughout the Asian crisis, with its microfinance borrowers continuing to make over 97 percent of the instalments that fell due in the period from mid-1997 to mid-1999. This strong repayment performance occurred at a time when the commercial banking system as a whole had non-performing loans as high as 60 per cent of portfolio. Savings mobilised through the Units grew dramatically over this period. Unit deposit-taking operations provided the lifeblood of liquidity for the bank as a whole throughout the crisis, and helped prop up BRI in the face of heavy losses incurred by its corporate lending division. In June 2004, 4046 BRI Units had about 3.15 million Kupedes loans outstanding, with an outstanding balance of about $26 billion. On the other side of the balance sheet, the Units had 30.4 million deposit accounts totalling more than $3.46 billion. Clearly lack of liquidity is not a constraint on the lending of the BRI Units, and with a loss rate close to 1 percent the Units could be considered too conservative in their lending.

**The ‘Bank Perkreditan Rakyat’ (Rural Banks)**

These small locally-based institutions comprise the second category of bank regulated by BI. The term ‘BPR’ (literally, people’s credit bank, but often translated simply as rural bank) is used in the Banking Act of 1992 and elsewhere to describe two categories of small regulated financial institution. The first is the ‘BPR non-BKD’, most commonly called simply ‘BPR’. These BPRs are much smaller than commercial banks and offer a more restricted range of services. These BPRs (both conventional and syariah) have a special place in the new ‘banking architecture’ being constructed by the central bank - they are encouraged to enter into linkages with commercial banks.

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3 Note: Where appropriate, rupiah amounts are converted to USD using a contemporary exchange rate. Such calculations are less useful in periods of considerable exchange rate instability.
The second category is called, formally, BPR-BKD, or more commonly, ‘BKD’ (Village Credit Body). They date back to the late nineteenth century and were formed under Dutch rule on Java and Madura islands as pioneer microcredit institutions. For simplicity, in this study the two categories of institutions will be called simply BPRs and BKDs. The BKDs are very much smaller institutions than the BPRs. Since both categories are subject to the Banking Act, both are in principle regulated and supervised by Bank Indonesia. In practice, BI has delegated the task of supervising the many small BKDs to Bank BRI, through the latter’s widespread network of retail branches.

**The BPRs (or BPR non-BKD)**

At end-September 2004, a total of 2162 BPRs (including 89 operating on syariah principles) had assets of about $1.75 billion and deposits of some about $1.205 billion and some 5.8 million depositors. The BPR is a product of the financial deregulation package of 1988, at which time they had a minimum capital requirement of only (then) $28 000. Under the 1992 Banking Act, the BPRs may accept time and savings deposits, but they may not issue cheques and do not have access to the payments system. They may provide credit, and in doing so are subject to the same limits as other banks, including related-party and large borrower limits. They may make and accept interbank deposits and deal in short-dated Bank Indonesia securities. More than 80 percent of BPRs are on Java or Bali, where only 60 percent of the population live. Most are limited liability companies in private ownership, operated for profit.

Typical loans offered by a BPR are short-term microloans for petty traders ranging with 3–6 month maturities, daily instalments, and flat rates of interest in the range 2–4 percent per month. The BPR system withstood the crisis, in general, much better than the commercial banks, although commercially marginal institutions were badly affected. BI responded in 1999 by strengthening prudential supervision and by intervening in some institutions. It has since liquidated almost 200 BPRs. BI also increased minimum capital requirements for establishing new BPRs, but has more recently loosened the requirements for BPRs opening new branches, while growing numbers of applications for new BPR licences suggest a strengthening recovery in the sector. In 2005, BI announced its intention to create an apex body for BPRs; initially as a pooling mechanism to assist member institutions manage liquidity. Eventually it will provide a range of other services including clearing, payments facilities and wholesale financing, as an element in the new banking architecture.

**The BKDs (or BPR BKD)**

The BKDs commenced operations more than a century ago and their status as banking institutions was affirmed by legislation in the colonial parliament. They were never effectively subject to central bank interest rate restrictions. This enabled them to set rates at sustainable levels well before the financial sector reforms of the 1980s. The 1992 Banking Act brought the BKDs under the supervisory jurisdiction of BI, which then gave them five years to meet the requirements of BPR status and to assume an appropriate legal identity. The deadline passed in 1997 with most not having done so. They now operate under an exemption granted by the central bank. This is practical recognition of the difficulty most would have in complying with BPR standards. They occupy a legal
limbo, a situation which casts a shadow over their status and longer-term future. They are supervised by Bank BRI on behalf of BI. Some 4,500 of these small locally-based institutions served almost 500,000 clients in mid-2004. They are found only in Java and Madura, and primarily in the provinces of East and Central Java.

BKDs are normally open only one day a week, on the local market day. In mid-2004, BKDs had loans outstanding of about $22.5 million to almost 400,000 borrowers at an average loan size of $56. They focus almost exclusively on credit, although a portion of each loan is held in a mandatory deposit. The balances accumulated by each client throughout the year are usually released at the end of the fasting month. In mid-2004 there were 400,000 accounts with an average balance of around $11. Mean savings and loans figures of these magnitudes suggest a low-income clientele and genuine microfinance. Despite their long history of sustainable operation at a modest and appropriate level of services, the BKD have not attracted the attention they deserve, either within Indonesia or overseas. The system as a whole had deposits with BRI’s retail branches totaling $11 million and accumulated reserves of $23 million, somewhat larger than the total credit outstanding. They could probably move to a more active lending stance while preserving current prudential standards. This might bring them into greater competition with Bank BRI (which is coincidentally their supervising institution).

**LDKPs: community-based non-bank financial institutions**

The acronym “LDKP” is applied generically to a range of savings and credit institutions which exist, with variations, in a number of provinces. One of this class, the LPDs of Bali, is the subject of the linkage case study prepared in parallel with this chapter. The Banking Act of 1992 obliged the LDKPs either to upgrade themselves to BPR status by 1997 or to cease operating. But a majority (including all the LPDs in Bali) have chosen not to come under the BI umbrella, or have not satisfied the criteria. They still operate as before, although their numbers are declining, except in Bali where they flourish.

Most of the LDKPs came into existence as local initiatives from 1970 when, amid recovery from the Sukarno years, Bank Indonesia authorized provincial governments to set up rural non-bank financial institutions. A total of 2,272 LDKPs were operating in mid-2000 serving more than 1.3 million borrowers. This declined to around 1,620 by 2002. As with the BKDs, the system is generally quite liquid, with savings and reserves adequate to finance lending and to permit significant deposits in the banking system. In terms of mean loan size, the LDKPs sit at roughly the same social level as the BKDs and on a very much lower level than the BPRs and the BRI Units. As with the BKDs, this suggests genuine microfinance. (See Table 1 for a comparison of the mean loan and deposit sizes for all these institutions).

Notwithstanding their excellent savings performance, the LDKPs, as non-banks, are prohibited from collecting deposits by Banking Law No. 10 of 1998. However the LPDs are authorised to take deposits within the boundaries of the traditional village. In the case of another variant of the model, the BKKs of Central Java, it is argued that they have a Ministry of Finance permit to mobilise deposits, pre-dating the banking law. The devolution of political decision-making since the end of the New Order has made it more
difficult for Bank Indonesia to enforce restrictions on deposit-taking. Local government autonomy is already encouraging a diversity of local-level financial sector experiments.

The LPDs of Bali differ from the provincial government controlled institutions in Central Java in being owned by local community organizations, and the glue of customary obligations and relationships is a significant factor in holding these small financial institutions together. In mid-2004, some 1,200 LPDs in Bali had loans outstanding of $95 million to some 317,000 clients at an average of $300 per loan. Savings deposits totalled $59 million with an average of $67. The LPDs are the major component of the LDKP system and with the rapid growth of their activities in recent years they may now constitute some 80 to 90 percent of its assets by value.

While the degree of social cohesion in local communities in Bali is probably exceptional, there may still be a lesson here concerning the value of community involvement. These community-owned institutions reach practically all households in Bali, are profitable, and have substantial retained earnings. Income is earned largely from lending, with loanable funds derived from savings, deposits and reserves. The Bali BPD operates as banker to the LPD system. The link between the BPD of Bali and the LPDs is the subject matter of a special case study prepared in parallel with this overview report.

Table 1 indicates the levels at which the bank and non-bank microfinance institutions described above fit into the rural financial landscape. While the 2000 data used is not recent, it shows the relative value between institutions. The BRI Units cater for clients with somewhat larger loan and deposit accounts than the BPRs, while the smaller institutions (BKDs and LDKPs) are operating at an entirely lower level. As suggested above, if the BRI units are serving a clientele that is relatively well-off and the BPRs have a somewhat more modest constituency, the BKDs and LDKPs appear to serve a genuine microfinance market.

Table 1: Comparative Loan and Deposit Account Sizes, Regulated Institutions

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>BRI Units</td>
<td>2.60</td>
<td>Rp2.55m/$340</td>
<td>16.7</td>
<td>Rp0.65m/$85</td>
</tr>
<tr>
<td>BPRs</td>
<td>1.68</td>
<td>Rp1.94m/$260</td>
<td>4.6</td>
<td>Rp0.25m/$33</td>
</tr>
<tr>
<td>BKDs</td>
<td>0.70</td>
<td>Rp0.22m/$29</td>
<td>0.6</td>
<td>Rp0.05m/$7</td>
</tr>
<tr>
<td>LDKPs</td>
<td>1.30</td>
<td>Rp0.28m/$35</td>
<td>n.a</td>
<td>n.a</td>
</tr>
</tbody>
</table>

Notes: Data for BRI relate to the Kupedes (loan) and Simpedes (deposit) accounts. Term deposits are excluded. Various dates during 2000.
Sources: BI and BRI

Savings and Credit Cooperatives
Cooperatives are regulated by the Ministry of Cooperatives and a Cooperative Law (No. 12 of 1967) was one of the first pieces of legislation of the New Order government. Cooperatives are primary instruments of state policy and independent cooperative
initiatives were discouraged. The only cooperatives in rural areas were those within the official KUD (Village Cooperative Unit) system. A new cooperative law in 1992 attempted to entrench the official cooperatives in certain areas of the economy. It also provided for official cooperatives to conduct ‘credit union’ activities, by setting up USPs (savings and credit units). These were to be outside the control or supervision of either BI or the Ministry of Finance (although cooperatives had been entitled to collect the deposits of members even prior to this new Act).

A presidential instruction after the fall of the New Order government (No. 18 of 1998) removed the rural monopoly which the official KUD system had enjoyed. Independent entities are now free to obtain licenses under the Act of 1992 to set up KSPs (Savings and Credit Cooperatives) and to set up cooperative networks. This offers opportunities for the emergence of new, poverty-focused, cooperative initiatives. Some NGOs have taken advantage of the new situation to set up financial services cooperatives. Islamic self-help savings and loan groups (the BMTs) are adopting the cooperative legal form, while the Agriculture Ministry microfinance programme, the P4K, is working towards having its self-help groups adopt cooperative status (text box 3).

There is a longstanding independent network of credit unions affiliated with the World Council of Credit Unions. This is the BK3I (Indonesian Credit Union Coordinating Organization) which under the New Order government inhabited a regulatory ‘grey area’ in which its legal standing was ambiguous and its opportunities for expansion limited. These credit unions are now able to regularize their legal position under the Cooperatives Act of 1992. There is also a proliferation of unregistered cooperatives, and some moneylenders have adopted these (referred to as Kosipa) as a front for their high-cost lending. Many USPs which originated within the KUD movement continue actively, although less tightly linked into the official system than before.

Some 36,000 cooperative savings and loan entities were registered in Indonesia in October 2000, according to data provided by the Ministry of Cooperatives. Those of interest in the context of rural finance comprised around 1,200 KSPs and some 5,200 USPs (the latter associated with the KUD cooperative system). The USPs have not been effective in financial intermediation in the past, having been too closely identified with unsuccessful mass credit schemes. This role discouraged attempts at sustainability and savings mobilization. Nonetheless the USPs is strategically located in the rural areas and has great potential for financial service provision. For this reason they are now receiving attention from PN Madani, the apex institution set up in 1999 after the change in the central bank’s legislation and functions. PN Madani is creating linkages with KSPs and USPs and encouraging the emergence of effective secondary cooperative bodies. Both primary and secondary cooperatives are tapped to act as executing agencies for credit (text box 1).

In addition there were some 29,600 urban USPs, mostly associated with workplaces. The rural KSPs had perhaps 0.7 million members and the rural USPs around 3 million. However the data are not reliable. The Ministry of Cooperatives and Small and Medium Enterprise Development is no longer a line department. It now has the status of a State Ministry and lacks the staff outside Jakarta to require reporting by cooperatives (hence the citation of dated cooperative statistics in this study). The registration of cooperatives
is now a regional government function, which further complicates efforts to monitor the system. Nevertheless, registration standards are required to be consistent with the national law and good practice is defined by a set of performance standards. Enforcement, however, is another matter.

**Informal Financial Institutions**

This section describes informal financial service organisations - unregulated, outside the scope of financial sector regulation. Here we deal, *inter alia*, with NGOs and Self-Help Groups (SHGs). It should also be noted that the Indonesian term *Lembaga Keuangan Mikro*, commonly translated as ‘microfinance institution’, or MFI, refers in practice to a wide range of entities active in provision of financial services for their members. These include both regulated and informal entities.

**‘MFIs’ and self-help groups**

Many informal Indonesian ‘MFIs’ are the survivors of structures originally created for mass financial service initiatives taken by various ministries during the late New Order period. These mass credit programs have left behind pockets of autonomous microfinance activity in many parts of Indonesia, often preserving ‘revolving funds’ originally disbursed by government agencies and channeling institutions. These informal MFIs are capable of benefiting from linkage relationships but are constrained by lack of an appropriate legal status (see text box 3 which deals with MFIs in Lombok). There is a blurring of boundaries between such MFIs and the self-help groups discussed in the next paragraph.

Self-help groups (SHGs) are completely informal organizations. Indonesian SHGs with savings and credit activities are often an outgrowth of *arisan*, a traditional group activity which is the Indonesian version of the rotating savings and credit associations found in most developing countries. Many SHGs have been founded by government and community organizations in connection with official programs (as in the case of informal MFIs discussed in the previous paragraph). Some SHGs are organized on Syariah principles. The secretariat of a microfinance umbrella group, the GEMA PKM, estimates 400 000 groups were formed during the 1990s, involving perhaps 10 million individual members. If true, this was enormous outreach, mostly to the poor and very poor. For the SHGs, as for the MFIs, there is scope for the better-managed among them to benefit from having access to the cooperative legal form. The expansion and capacity building of self-help groups is an activity in which NGOs appear to have particular comparative advantage, especially in the more positive climate for NGO activity since the end of the Suharto era.

**Non governmental Organizations**

NGOs played a relatively subdued role in many spheres of community action under the New Order government. Despite that, procedures for establishing and registering an NGO, using the legal form of a *yayasan* (or foundation) were relatively simple. Supervision was minimal unless an NGO attracted political attention. NGOs conducting microfinance require no permission to extend credit, and there are no reporting requirements or supervisory arrangements for such activities. However NGOs are forbidden to mobilize the savings of members unless these are deposited directly in a regulated financial
institution. (This should not be confused with the issue of whether small financial institutions registered with local authorities are entitled to collect savings, as discussed in the case of LDKPs, above. Some larger NGOs have set up their own licensed BPRs to overcome the problem. Also, since 1998 the new freedom to set up savings and loan cooperatives has offered another solution to this problem. However, for NGOs unable to take either of these paths, the prohibition on mobilizing even compulsory savings in conjunction with lending is a constraint.

Text Box 2: KSU ‘Karya Terpadu’: ‘New’ co-operatives originating from a mass credit programme

KSU stands for ‘Koperasi Serba Usaha’, meaning a multi-purpose cooperative, but savings and credit are the core activities of this entity, located in Rarang village on the island of Lombok in NTB Province. The membership is predominantly female and there are other services, including literacy classes and vocational training for the benefit of members.

KSU Karya Terpadu is the leading entity among 14 cooperatives with a combined membership of 5,110 at end-2003, more than 90 percent of whom were women. Five of these cooperatives have legal status while the others were still informal. All originated from self-help groups formed for the long-running P4K savings and credit program, conducted by the Ministry of Agriculture, with BRI as the lending institution, and with support of a number of international agencies from time to time, including UNDP, FAO and IFAD. This group of cooperatives thus represents former SHGs which have ‘graduated’ from a major state credit program and are in process of achieving legal status appropriate for linkages with larger institutions. The cooperatives provide loans to individual members, as well as to groups sharing joint liability, as in the past under the P4K program.

Karya Terpadu and its affiliates are now independent. They have registered a secondary co-operative (Pusat KSU Karya Terpadu Madani) as an umbrella entity to provide services to member institutions, including education and development for staff and members, management, supervision and audit services, and liquidity management. The new entity banks with the local branch of Bank BRI. KSU Karya Terpadu, the leading primary cooperative in the group with 655 members, had established a relationship with PN Madani, the national apex institution, but the secondary cooperative, despite its name, had yet to do so. The secondary cooperative hoped to access working capital loans from Madani and eventually to achieve BPR status with Madani’s technical and financial support. In the meantime, the cooperative service of the local (Kabupaten) government provided supervision and training services and was the registering authority.

The leading primary cooperative, Karya Terpadu, had good working relationships with the Rarang village government (BPD). A number of prominent citizens had shown support for the cooperative by taking out membership in it and the BPD had deposited funds. The BPD had determined that special poverty alleviation funds from higher levels of government should be passed to the community via the cooperative (for example the Subsidi BBM allocated as block grants to village governments to compensate the poor for high fuel costs). This and other national and provincial level funding streams strengthened Karya Terpadu financially and underwrote its early progress. The cooperative had also accessed some working capital from PN Madani. However Karya Terpadu appeared to be more than just a channeling institution for government funding and appeared to have developed a genuine capacity for financial intermediation and to exhibit strong grass roots leadership.
NGOs had been involved in mass poverty alleviation programs of the New Order which involved elements of microfinance, especially the IDT (or ‘backward villages’ program, of 1993-1997). They were given a key role in ‘social safety net’ programs set up to assist recovery from the financial crisis after 1997. Their primary function in such schemes has been to act as social intermediaries, preparing “self-help groups” of the poor to participate. The NGO sector is quite diverse; relatively few NGOs in Indonesia are specialist microfinance providers. One multi-purpose NGO, possibly the largest in Indonesia with some 700 employees, is Yayasan Bina Swadaya (Foundation for Support of Self-reliance). Bina Swadaya is committed to the group method of community organization, for a range of social objectives. It has been a contractor assisting with the formation and training of self-help groups for official and donor-supported microfinance programs such as the PHBK and the IDT. Bina Swadaya has also purchased a number of BPRs to which it links self-help groups. It has formed a cooperative which attracts deposits from a middle class constituency and lends to the poor. Bina Swadaya also facilitates a national umbrella group for microfinance, GEMA PKM.

Other NGO activities in microfinance are linked with international NGOs such as Opportunity International and Catholic Relief Services (CRS). There is also an active but relatively minuscule Grameen Bank replication movement that has struggled to achieve outreach under Indonesian conditions. One of the more interesting NGO activities, from the perspective of linkages, is the establishment of networks of BPRs. Thus CRS initiated a partnership with a local entity, PT UKABIMA, an equity investment company set up specifically to take equity in, and to provide technical assistance to, BPRs.

**A Governmental Apex Institution: PT PN Madani**

PN Madani is a state-owned enterprise set up in 1999 to assume responsibility for certain ‘liquidity credit’ schemes previously operated by BI, in the context of a broader corporate mission to support the SME and cooperative sectors. PN Madani is a wholesale lending agency, an ‘apex’ institution, which will make use of existing financial institutions rather than lending directly to final users (text box 1). PN Madani is an important new feature in the landscape of financial linkages. The liquidity credits PN Madani acquired were to have a restricted time-span. The interest rate subsidies were to be a specific charge on the national budget, and were approved initially for only three years, but have since been extended. Much of the credit is directed to the needs of agricultural producers, and much of it continues to be channeled via rural primary cooperatives, the KUD. These activities are a relatively small element in PNM’s ambitious business plan, which calls for the company to become a venture capitalist to the SME sector. PN Madani has a microcredit ‘window’ through which credit is made available to intermediary institutions. The resources available were augmented during 2004 by the release of new funding backed by a government debt issue, known as SUP 005. PN Madani’s liquidity credits transferred from Bank Indonesia are provided interest-free by the government, and its lending rates to linked institutions range between 9 and 16 per cent per annum. It is thus the beneficiary of a substantial interest rate subsidy, although it is intended this should be phased out over time, raising PN Madani’s cost of funds and challenging it to achieve sustainability.
5. The legal and regulatory framework

This section describes the responsible legal and regulatory jurisdictions. Table 2 provides a summary.

Table 2: Financial Institutions Engaged in Linkages, by Regulatory Status

<table>
<thead>
<tr>
<th>CATEGORIES</th>
<th>Linkage partners subject to central bank regulation</th>
<th>Linkage partners under other financial regulation</th>
<th>Linkage partners with no explicit financial regulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Institutional</td>
<td>Commercial Banks (Bank Umum)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Commercial banks (government &amp; private)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Commercial Banks (other) (Bank Umum, other)</td>
<td>Regional Development Banks (BPDs)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Other regulated banks Bank Perkreditan Rakyat (BPR non-BKD)</td>
<td>(Peoples Credit Banks, or ‘Rural’ Banks) with private, local government or cooperative owners</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Other regulated banks Bank Perkreditan Rakyat (BPR-BKD)</td>
<td>Badan Kredit Desa (BKDs, or Village Credit institutions)</td>
<td>BKD supervision ceded to Bank Rakyat Indonesia by BI</td>
</tr>
<tr>
<td></td>
<td>Non-bank financial institutions (local area) LDKPs</td>
<td>e.g., BKKs (Java), LPDs (Bali), subject to local government regulation and BPD supervision</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Apex (or second tier) entity PN Madani</td>
<td>Ministry of Finance</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cooperatives, credit unions</td>
<td>KSPs &amp; USPs, including Syariah, also credit unions. Subject to Cooperatives Act.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Informal DFIs NGOs, unregistered MFIs, Self Help Groups</td>
<td></td>
<td>NGOs, MFIs, BMT (syariah) SHGs, arisan</td>
</tr>
</tbody>
</table>

Our focus is on the various institutional models which engage in linkages and also on the forms which such linkages take. To illustrate the complexity, Table 2 lists institutions engaged in linkages of one sort or another, both formal and informal. They are classified by their regulatory status and are categorized as being regulated by Bank Indonesia, or by
For reasons explained above, the formal/informal dichotomy is not emphasized in Table 2. Instead, the distinction between modes of regulation provides the necessary dividing line. In all cases the institutions named are primarily financial in function rather than producing both financial and non-financial services. Most are purely financial. Not all provide both savings and credit services, however, and therefore not all are providing full services of financial intermediation. Some in the voluntary sector are concerned also with social intermediation. Others in the cooperative movement combine financial services with non-financial services of the type typically associated with agricultural cooperatives.

Text box 3: PHBK - the project linking SHGs with Banks

Technical assistance for the PHBK was supplied by the German agency GTZ. This activity went through a number of phases, from project to programme, marked principally by changes in the types of formal financial institutions involved and the DFIs employed by them for grassroots operations. The formal PHBK programme and GTZ’s involvement with it, ceased in 1999. However a linkage program, built on the foundations of the PHBK and employing essentially the same mechanisms, continues with Bank Indonesia support and monitoring. In a more general sense, the concept of linkages has now been formally incorporated into national policy for a new Indonesian ‘Banking Architecture’.

6. Linkage models in the Indonesian context

Current and recent rural- and micro-finance activities in Indonesia incorporate an array of institutional models bewildering to the newcomer in their variety and novelty. Activities range from those of profitable, regulated financial institutions operating at best practice levels to opportunistic and politically-driven mass credit schemes. A number involve linkages between formal financial institutions and informal development financing institutions. However, a simple duality of formal and informal institutions will not suffice to describe the more complex reality of rural financial service provision. Indonesia has many small, community-owned formal financial institutions that are subject to regulation, with few analogues in other financial systems, in terms of their small scale and strong local character. Many of them are engaged in linkages with major financial institutions and also with grassroots financial actors. These small institutions occupying intermediate positions in the financial hierarchy are often involved in chain relationships, rather than simple linkages. This is not to say that Indonesia lacks direct formal/informal institutional linkages. In fact Indonesia was the first country in Asia to trial such linkages. Commencing 1989, as mentioned above, Indonesia conducted project 'PHBK' (Project Linking Banks with Self-help Groups), in which BI was the implementing agency (text box 3).

Table 3 describes pure financial linkages, such as the flow of loanable funds from superordinate institutions to subordinate ones and the mobilization of savings from subordinates. It employs a distinction between cases where lending is funded by direct financial intermediation and others where lending via apex institutions is funded by government appropriation of funds. This latter scenario is based on changes implemented since 1999 and described in text box 1. The discussion draws upon the categories described in table 3, distinguishing between situations arising as the result of market
forces (‘commercial’ relationships) and those which occur as the result of government initiative or central bank moral suasion. Many private banks are undergoing rehabilitation under close supervision of BI, while others may seek the goodwill of regulatory authorities for a variety of reasons. Similarly, financial institutions owned by governments at the national, provincial or local levels have public service objectives beyond immediate profitability. It will be useful in observing the linkage relationships that have grown up in the financial system to consider how far these would arise without the influence of such non-market considerations.

**a) Simple bilateral linkages**

Simple bilateral linkages between commercial banks and BPRs are encouraged as an element in the new ‘banking architecture’. At least two private commercial banks, Bank Niaga and Bank Danamon, have begun to initiate such relationships on a commercial basis, although this may also reflect central bank moral suasion directed to encouraging micro- and small business lending by the private commercial banks.

**Table 3: Modes of Financial Linkage between Institutions**

<table>
<thead>
<tr>
<th>Sources of loanable funds, savings and capital flows</th>
<th>Modes of financial linkage between Indonesian financial institutions serving a poor and low-income rural clientele</th>
</tr>
</thead>
</table>
| **a)** Flows are financed by direct financial intermediation, including mobilization of savings from subordinate entities. | **a. Simple bilateral linkages**  
O-------------------------------------------------O------------> Final  
borrowers  
Commercial bank  
Rural bank (BPR) |
|  
O-------------------------------------------------O------------> Final  
borrowers  
Commercial bank  
Non-bank financial institutions (LDKPs)  
BKDs |
|  
O-------------------------------------------------O------------> Final  
borrowers  
Rural bank  
Self-help group |
| **b)** Flows are now (since 1999) backed by state debt, subsidies are transparent, and (in principle) subject to a hard budget constraint. | **b. Bilateral linkages (with apex institutions)**  
O-------------------------------------------------O------------> Final  
borrowers  
Apex institution  
BPR  
LDKP  
KSP |
| **c)** Flows financed by direct intermediation, | **c. Linkage chains** |
Another set of bilateral linkages is that between provincial government-owned commercial banks and locally-based LDKPs. The BPDs (provincial development banks) are responsible for supervision of, and varying degrees of technical assistance to, the LDKPs. As might be expected they perform these functions with an eye to provincial government policy for the expansion of financial services in rural areas. LDKPs hold accounts with their BPDs and resort to them for liquidity management as necessary. A similar relationship exists between Bank BRI and the BKDs. BRI branches have been delegated by the central bank to supervise and otherwise support BKDs, and receive financial compensation for doing so. BKDs also deposit their excess liquidity with BRI and can borrow from the bank in the event of liquidity problems.

Bilateral linkages continue to exist between BPRs and informal entities, employing methods developed during the now-discontinued PHBK program (text box 3). BI continues to devote training and monitoring resources to these linkages.

**b) Simple bilateral linkages involving apex institutions**

Simple bilateral linkages between apex institutions and subordinate entities include those between PN Madani and Bank Mandiri on the one hand and a variety of small localized institutions with access to low-income people in the rural sector. Both of these are state 

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4 Models with SHGs may involve the intervention of an NGO as a ‘social intermediary’.
institutions with mandates for public service (although Bank Mandiri is now part-privatized). PN Madani is purely an apex institution, dealing only with financial institutions, whereas Bank Mandiri is a licensed financial institution which deals with final borrowers as well as operating in an apex-like fashion by creating linkages, as encouraged by the new financial architecture. Bank Mandiri appears unique among commercial banks in the extent to which it is incorporating the linkage mechanism into its growth strategy.

The microcredit intermediaries selected by PN Madani as its focus include mostly conventional BPRs but it has a special concern for Syariah BPRs and even has relationships with Syariah commercial banks. PNM makes working capital loans for their expansion, and subordinated loans to strengthen the capital base of selected institutions. These facilities enable Madani to exert influence over management to effect improvements in operating methods and financial status. PN Madani’s 2003 Annual Report records it has working relationships with around 800 BPRs, either for financing or technical assistance. Via these latter institutions PN Madani links with the BMT (Islamic self-help groups). It also links with KSPs (Savings and credit cooperatives) of which there are around 1,200 in operation. Madani deals with these via their regional umbrella entities, secondary cooperatives known as IKSPs. PNM makes capital injections into these IKSPs as well as providing working capital loans. Services provided by PN Madani to its linkage partners include management consulting and technical services, training in the application of standardized systems and procedures, including IT services, and the placement of Madani advisory staff in selected institutions. Client institutions are also introduced to other technical service providers as appropriate, including independent rating agencies.

Bank Mandiri is positioning itself as an apex institution catering for the most bankable among the rural banks, by comparison with PN Madani which it characterizes as dealing with the less dynamic institutions. Mandiri had established formal linkages with some 700 BPRs by mid-2004. It planned to reach 1,000 BPRs (almost half the present total) by the end of 2004 and has ambitious targets for further expansion of outreach to what it believes will become a growth sector as part of the ‘new architecture’. Bank Mandiri’s linkage relationship with a BPR comes with a package of services. Aside from credit lines and access to program financing, Mandiri also provides training and assists with the installation of a standard IT system. Mandiri sees this as promoting the government’s objective to increase the availability of financing for micro- and small business activity, and as providing an extension of the bank’s own distribution network for its loan products. These include program credits it is administering as part of the ‘long tail’ of former Bank Indonesia liquidity and SUP 005 credits for micro- and small enterprise lending (Text box 1). Bank Mandiri was responsible for a third of all lending to the BPR sector in mid-2004 (around $21 million, as compared with PN Madani’s $4 million). The numbers are small, and delays in disbursement of SUP 005 funding have been a matter of public comment.
c) Linkage chains
In Indonesia it is rather difficult to identify fully commercial chains, that is, linkages involving three parties and operating in a market situation, and that exist to provide services for a low-income rural constituency. Rather, such chains appear to operate as a matter of public policy or at least to be initiated by government institutions. Thus the provincial development banks, BPDs, provide support to LDKPs and to provincial government-owned BPRs. Some of these, in turn, serve informal MFIs and community-based self-help groups. Here the relationships are often influenced by the disbursement of program funding, for example, subsidies distributed in recent years to local governments to compensate for high fuel prices (see text box 2). No doubt ‘pure’ cases exist, and cases where genuine financial intermediation forms some element in the relationship are likely to occur.

Another chain relationship is that deriving from the desire of commercial banks, members of the association of private commercial banks, PERBANAS, to access BPRs. The association has set up a foundation, DABANAS, as an intermediary for this purpose. It receives a margin over the lending rate of the member banks for passing funds through to qualified BPRs. It is hard to see any motive for these transactions other than banks’ need (for whatever reason) to comply with BI’s ‘credit policy’, urging them to support subordinate banks in the BPR sector. The foundation provides a means of doing this at minimal transaction cost. The DABANAS structure is a convenient one for present purposes, even though there is no longer a formal compulsion for banks to comply. Where a commercial bank has a strategic motive for linking with BPRs it is likely to want to do so directly, as with the cases of Bank Niaga and Bank Danamon, mentioned under a.), above.

d) Linkage chains from apex institutions
While Apex type linkages are usually directed to public policy goals, Bank Mandiri is also serving longer-term strategic interests of market positioning and market development. Thus Bank Mandiri has recently acquired the role as implementing agency of a bilateral aid project (surrendered by Bank Indonesia as a result of its loss of the ‘agent of development’ function). This is the Asian Development Bank-funded ‘Micro Credit Project’ which commenced in 1996. In this project, BPRs and other small financial institutions linked with Bank Mandiri will be executing banks, targeting groups of the poor in farming and fishing communities. This three link chain will prove profitable for Bank Mandiri if the lending is well-executed and should give the opportunity for institutional learning and market development. Bank Mandiri is conscious of the value of BRI’s rural outreach for savings mobilization and of the contribution to BRI’s group profit from rural- and micro-operations.

PN Madani’s mandate is determined by public policy. It must do policy lending, funded by the former BI liquidity credits, while managing the transition to an accountable and transparent regime for such lending. PN Madani operates in a policy environment in which there is greater consciousness of the distinction between ‘micro’ and ‘small’ enterprise and their differing financial needs. PN Madani also support of Islamic financial
institutions, especially those based in community and grassroots action. These syahriah institutions do not require collateral for lending, as a matter of religious principle.

e) An agribusiness linkage
PT HM Sampoerna is a company associated with a major Indonesian cigarette manufacturer. It sources leaf from growers in Lombok, NTB Province. Sampoerna assures supply and maintains quality by production contracts with growers. Sampoerna acts as the financial intermediary in a linkage between the funding source (a venture capital financier) and the grower, as well as providing specialized inputs to the production process and being the final purchaser of product. Unfortunately, neither hard data on costs and returns nor details of contractual arrangements between the company and growers were available. Sampoerna currently has around 1200 contracted smallholders. Some sixty mobile technicians deal directly with growers, visiting them on almost a daily basis throughout the production cycle to assure close compliance with standard procedures. This monitoring enables the company to estimate the quantity and grade of the harvest, as a check against subsequent deliveries from growers. Sampoerna recovers extension costs from its operating and interest margins, rather than by levying user charges on growers.

Sampoerna advances $800 to $1,200 per hectare and requires a larger investment from the grower, but labour and land inputs can account for part of the required grower investment. The timing and method of loan delivery are designed to ensure that the inputs are used as recommended – much of the credit is extended in kind, and on time, in the shape of seed, fertilizer and pesticide. Besides offering production loans, Sampoerna also finances investment in on-farm processing facilities. Calculating the real cost of credit supplied under this system and the distribution of benefits between the parties would require, apart from details of the nominal interest rate, the calculation of fair market prices for inputs and services supplied to growers and estimates of open market prices for leaf. Sampoerna itself purchases all inputs and grades the leaf delivered by contracted growers. This makes for limited transparency in this critical aspect of the relationship. As against that, there is evidence of some competition in the open market for leaf. This might represent a disincentive to the exercise of monopsonistic power. However, Sampoerna has good information concerning the quality and quantity of each grower’s crop and its contracts (which the writers have not seen) may include effective disincentives to the independent sale of leaf.

Conclusion

This study of the variety of linkage mechanisms observable in Indonesia, and of the contexts in which they have developed, reveals that good policy can exist and even flourish alongside bad. It suggests that efficient commercial mechanisms can survive in a politicized lending environment, perhaps because the market reach of politicized lending is likely, by definition, to exclude many bankable micro-borrowers. The study confirms the considerable demand for savings, especially from the financially-excluded social groupings. The potential for mobilization of loanable funds by institutions serving the excluded strata of rural communities is sufficient to permit the emergence of viable
processes of financial intermediation within those communities. It seems as if small, well-managed financial institutions, anchored in their communities, operating within a supportive policy environment and subject to adequate regulation and supervision, are capable of extending financial services to previously excluded segments of the rural population\(^5\). Together with the case study of the linkage arrangements involving one such class of local institution (the LPDs of Bali) this study suggests there is genuine utility in commercially-motivated linkage arrangements for financial institutions involved in those communities.

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\(^5\) This generalization might prove less well-founded in societies less segmented and lower in population density than those of inner Indonesia, principally the islands of Java and Bali. The less densely populated and less diversified local economies of ‘outer Indonesia’ have generally less successful practice to show in microfinance and linkage operations.