The microfinance linkages in Indonesia: An overview and taxonomy

Keterkaitan lembaga pembiayaan mikro di Indonesia: suatu tinjauan kritis dan taksonomi[1]

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Abstrak

Berbagai macam lembaga keuangan terlibat dalam hubungan-hubungan pelayanan jasa keuangan mikro (linkages) di Indonesia. Sebuah 'linkage' antar dua lembaga sederhana baik formal ataupun informal tidak dapat menjelaskan tata hubungan antar lembaga yang sebenarnya. Indonesia memiliki lembaga keuangan kecil formal yang jarang dijumpai di tempat lain. Banyak dari lembaga keuangan kecil formal tersebut terlibat dalam rantai-rantai hubungan dengan lembaga-lembaga keuangan utama dan para pelaku keuangan di tingkat akar rumput. Indonesia juga memiliki lembaga-lembaga 'Apex' yang didirikan untuk menciptakan hubungan-hubungan pelayanan keuangan mikro. 'Linkages' memiliki peran eksplisit dalam "Arsitektur Perbankan Indonesia" yang disusun oleh Bank Indonesia. Artikel ini menyusun taksonomi dari linkages di Indonesia, berdasar pada perbedaan-perbedaan akibat kekuatan pasar dan akibat pengaruh (kebijakan) pemerintah.

Kata Kunci: linkage keuangan mikro dan Indonesia

Abstract

A wide range of financial institutions engage in linkages in Indonesia. A simple formal/informal duality is inadequate to describe the nature of these arrangements. Indonesia has small, regulated financial institutions that have relatively few analogues elsewhere. Many of these engage in chain relationships with major financial institutions and grassroots financial actors. Indonesia also has apex institutions set up to create linkages, and linkages have an explicit role in a new 'banking architecture' being created by the central bank. The paper develops a taxonomy of linkages, based on a

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distinction between arrangements that reflect market forces, and those occurring as the result of government or central bank initiative.

Key words: microfinance linkage, and Indonesia

Introduction

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 have ranged from those of profitable, regulated financial institutions operating at world's 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 in Indonesia. The country has many small, community-owned formal financial institutions that are subject to regulation. These have relatively 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.

Recognizing the particular richness of linkage arrangements available for study in Indonesia, the authors decided to conduct an overview study as part of a cross-country study of linkages implemented by FAO for the Ford Foundation. The overview presented here was supplemented by a case study of one particular linkage relationship, that between the provincial government bank in the Indonesian province of Bali and the Balinese LPDs, a set of small local non-bank financial institutions (Budastra, forthcoming). Rather than being a case study, this overview was intended to give a general descriptive mapping of different linkage models that exist in Indonesia and to derive from that a taxonomy of such linkages.

Status of financial institutions involved in linkages in Indonesia

A rich variety of financial institutions are involved in the microfinance linkages in Indonesia. The linkage partners include: financially regulated banks, community based financial institutions, saving and credit cooperatives, and unregulated financial institutions –(Table 1 to be omitted) The next section provides a brief introduction to these various institutions. Many of them originated during the period of the so-called *New Order* government of President Suharto (1967-1998). Linkages between financial institutions inspired by government programs remain as an important feature of the Indonesian financial landscape today.

Regulated banks

Formal institutions regulated by Bank Indonesia (BI, the central bank) include the commercial banks. A sub-set of these consists of Regional Development Banks (BPDs) owned by provincial governments, which are of particular significance for linkages. While they act as bankers to their governments, the BPDs also perform some apex functions. BPDs are employed as wholesalers to convey loanable funds from governments and donor agencies to smaller linked financial institutions. Some BPDs also have responsibility for supervision of certain small formal financial institutions operating within their provinces. This is because these institutions (known collectively as the LDKPs) operate under provincial, rather than central bank regulations.

A second class of banks regulated by Bank Indonesia consists of small and locally-based institutions known as *Bank Perkreditan Rakyat* (BPR), and generally translated as 'rural bank' which offer a more restricted range of services, compared to commercial banks. The banking Act of 1992 differentiates rural banks into two, namely: 'BPR non-BKD' and 'BPR-BKD (Steinwand 2001, Robinson 2002**)**. service-For simplicity, in this study the two categories of small bank institutions will be called simply BPRs and BKDs.

BPRs have a special place in a new 'banking architecture' being constructed by the central bank, in that they are encouraged to enter into linkages with commercial banks. Linkages are thus an explicit element in national banking policy. Most BPRs are limited liability companies in private ownership, operated for profit. Originating from financial deregulation in the 1980s, the BPRs are an impressive example of the mobilization of private capital for microfinance. Some are in chains associated with commercial banks or NGOs. Others are registered as cooperatives, while some are organized on Islamic principles (BPR *Syariah*) and some are owned by local governments.

BKDsdate back to the late nineteenth century and were formed under Dutch colonial rule, making them pioneer MFIs. They 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, Bank Indonesia has delegated the task of supervising the BKDs to a major commercial bank, Bank BRI.

The LDKPs

Community-based nonbank financial institutions, known as LDKPs, were mentioned above in connection with the Provincial Development Banks (BPDs). The acronym "LDKP" is applied generically to a range of savings and credit institutions which exists in a number of provinces (Steinwand 2001, Robinson 2002). One set of these, the LPDs of Bali, is the subject of the linkage case study prepared for FAO in parallel with this overview (Budastra, forthcoming). The Banking Act of 1992 obliged the LDKPs either to upgrade themselves to the status of regulated BPRs by 1997 or to cease operating. But a majority (including all the LPDs in Bali) have chosen not to come under the umbrella of central bank regulation, or have not satisfied the criteria. In a sense, they are ‘unfinished business’ left over from financial reforms of the 1980s.

Most of the LDKPs came into existence as local initiatives during the period from 1970 when, amid recovery from the economic chaos of the Sukarno years, Bank Indonesia authorized provincial governments to set up rural non-bank financial institutions. Significantly, these institutions benefited from being ‘under the radar’ of interest rate caps imposed upon the banking system at that time. Many of the more efficient LDKPs prospered while the banking system laboured under heavy regulation. The numbers of LDKPs are now declining, except in Bali where they flourish. A total of 2,272 LDKPs were operating in mid-2000, serving more than 1.3 million borrowers. However the number fell to around 1,620 by 2002. The financial strength of the Balinese institutions, together with the capacity of the Bali Provincial Government to protect them from closure by national authorities, seems likely to assure the LPDs’ continuing operation for some time.

Both the BKD and LDKP systems are 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 village-based ‘units’ of Bank BRI. Table 1 provides a comparison of the mean loan and deposit sizes for these institutions. The village ‘units’ of Bank BRI, a world-leading institution in ‘micro-banking’, are included in table 2 for purposes of comparison.

Table 1 has been compiled to indicate the levels at which the bank and non-bank microfinance institutions described above fit into the rural financial landscape. The data (for year 2000) are not recent, but their value lies in suggesting the relativities between institutions, which are unlikely to have changed. On the evidence, 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. Thus 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 of the Regulated Institutions

Institution	Loan Accounts: Numbers. (Million)	Mean Balance Outstanding per Account (Rp. M/$US)	Deposit Accounts: Numbers (Million)	Mean Balance per Account (Rp. M/$US)
BRI Units	2.60	2.55/340	16.7	0.65/85
BPRs	1.68	1.94/260	4.6	0.25/33
BKDs	0.70	0.22/29	0.6	0.05/7
LDKPs	1.30	0.28/35	n.a	n.a

Sources: BI and BRI. Various date during 2000

Savings and credit cooperatives

Savings and credit cooperatives are other significant partners in linkages in modern Indonesia. Multi-purpose cooperatives were a primary instrument of state policy under Suharto's New Order and independent cooperative initiatives were discouraged. In 1998 a new government removed the rural monopoly which the official cooperatives had enjoyed. Independent entities are now free to obtain licenses to set up KSPs (Savings and Credit Cooperatives) and to form 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 a long-running Agriculture Ministry microfinance program, the P4K, is working towards having its self-help groups adopt cooperative status. The remaining savings and credit cooperatives dating from the Suharto era (known as USPs) are strategically located in rural areas and still have great potential for financial service provision. For this reason they are now receiving attention from PN Madani, a financial apex institution set up by the Government in 1999. PN Madani is creating linkages with both the USPs and the newly-formed KSPs. It also encourages the emergence of effective secondary cooperative bodies. Both primary and secondary cooperatives are being tapped to act as executing agencies for credit provided by PN Madani.

MFIs, NGOs and self-help groups

Finally, the discussion turns to financial service organisations that are outside the scope of financial sector regulation, such as MFIs, NGOs and Self-Help Groups. 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.

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. While politically-driven, these mass credit programs have nonetheless left behind pockets of autonomous microfinance activity in various parts of Indonesia, sometimes preserving 'revolving funds' originally disbursed by government agencies and channelling institutions. Such informal MFIs appear capable of benefiting from linkage relationships but are constrained by lack of an appropriate legal status. There is a blurring of boundaries between such MFIs and self-help groups.

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 organisations in connection with official programs. Some SHGs are organised on Syariah principles. The secretariat of a microfinance umbrella group, the GEMA PKM, estimates that as many as 400,000 groups were formed during the 1990s in connection with one program or another, involving perhaps 10 million individual members. If this is so, there was enormous outreach to the poor and very poor, even if many SHGs were short-lived. For the SHGs, as for the MFIs, there is scope for the better-managed survivors to benefit from having access to the newly-available cooperative legal form.

Linkage models found in Indonesia: A taxonomy

Table 2 maps all the major linkage models found in Indonesia. It is concerned with linkages of a purely financial nature, such as the flow of loanable funds between institutions and the mobilization of savings. A number of variables are distinguished to enable a taxonomy of linkages to be described. Thus, the table employs a distinction between cases where lending is funded by direct financial intermediation and others where lending via apex institutions, such as PN Madani, is funded by government appropriation of funds. This latter scenario is based on changes implemented since 1999 and described above

Table 2. Modes of Financial Linkage between Institutions: a taxonomy

Sources of loanable funds, savings and capital flows	**Modes of financial linkage between Indonesian financial institutions serving a poor and low-income rural clientele**
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) Non-bank financial institutions (LDKPs) O----------------------------O------------> Final borrowers Rural bank Self-help group
b) flows are backed by state debt, subsidies are subject to a hard budget constraint.	**b. Bilateral linkages (with apex institutions)** O-----------------------------O------------> Final borrowers Apex institution BPR LDKP KSP
c) flows are financed by direct intermediation, including mobilization of savings from subordinate entities.	**c. Linkage chains** O-----------O------------------O-------------> Final borrowers BPD BPR Self-help group LDKP O-------------O---------------O----------→ Final borrowers Commercial Bank DABANAS BPRs Foundation
d) flows are backed by state debt and subsidies are constrained by the state budget.	**d. Linkage chains (from apex institutions)** O-----------------O--------------------O----> Final borrowers Apex institution KSP(secondary) KSP (primary) BPR KSP Syariah BMT LDKP
e) flows are commercial, delivered via non-financial intermediaries	**e. Agribusiness financing via non-financial entities** O-----------------O-----------------------> Final borrowers (Producers) Venture capitalist Agribusiness entity Commercial Bank

The discussion that follows distinguishes 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. Thus, since the Asian financial crisis, many banks in Indonesia 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, or without the intervention of apex institutions such as PN Madani.

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.

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. 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 deposit their excess liquidity with BRI and can borrow from the bank in the event of liquidity problems. Bilateral linkages also exist between BPRs and informal entities.

Simple bilateral linkages involving apex institutions

Simple bilateral linkages between apex institutions and other 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 institutions with mandates for public service (although Bank Mandiri is now part-privatized). P N 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. Madani makes working capital loans for their expansion, and subordinated loans to strengthen the capital base of selected institutions. PN Madani's 2003 Annual Report records it had 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, many of which have assumed cooperative legal identities and which PN Madani aims to upgrade to BPR Syariah status. It also links with KSPs (Savings and credit cooperatives) of which there are around 1,200 in operation. Madani deals with these via secondary cooperatives which obtain capital injections and 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.

Bank Mandiri positions itself as an apex institution catering for the most bankable among the rural banks. 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'. 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 former Bank Indonesia liquidity and SUP 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 as yet, and delays in disbursement of SUP funding have been a matter of public comment.

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.

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, known as 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 sub-ordinate banks in the BPR sector. The foundation provides a means of doing this at minimal transaction cost. DABANAS itself had its origins in an earlier, mandatory, policy by which commercial banks were obliged to devote a certain proportion of total lending to SME borrowers. 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 commercial or 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.

Linkage chains from apex institutions

Such institutional chains are very largely directed to goals of public policy, although perhaps those in which Bank Mandiri is involved could be seen as 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). 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 Bank 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 is charged with continuing 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 now greater consciousness of the distinction between 'micro' and 'small' enterprise and of the differing financial service needs of these two levels of economic activity. Partly as a means of addressing this issue, and partly for political ends, PN Madani has a brief for the support of Islamic financial institutions, especially those based in community and grass roots action. These syahriah institutions do not require collateral for lending, as a matter of religious principle. Madani also has a special brief for the support of cooperative financial service institutions.

An agribusiness linkage

PT HM Sampoerna is a company sourcing tobacco leaf from growers in NTB Province. Its relationship with growers provides an example of a commercial linkage relationship. Sampoerna assures supply by production contracts with growers. It 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 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. 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. It also grades the leaf delivered by contracted growers so that it is difficult to assure transparency in this critical aspect of the relationship.

Conclusion

This study of the variety of linkage mechanisms observable in Indonesia suggests that good policy can exist and even flourish alongside bad. It suggests that commercial mechanisms can survive in a politicized lending environment, perhaps because the selective reach of politicized lending is likely to exclude many bankable micro-borrowers. Further, the study indicates that considerable demand for savings services exists, sufficient to permit the emergence of viable processes of financial intermediation within rural communities. Small and well-managed financial institutions, anchored in the communities they serve, 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.

Together with a companion 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 in rural communities. The support of such linkages is central bank policy, embodied in its planning for a 'new banking architecture' for Indonesia. However, linkages are still employed extensively in Indonesia for the channelling of government program credit, and such linkages continue to introduce significant elements of subsidy into rural- and micro-finance. Bad policy continues to make life difficult for good institutions attempting to survive in Indonesia's highly segmented rural financial market.

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