Finance for the Poor

From Subsidized Schemes to Sustainable Finance

Providing finance to the poor of Indonesia can help them work their way out of poverty. The government is clearly committed to this objective. It subsidizes many credit schemes for small business operators, but these schemes are not delivering. They suffer from bad program design, inadequate incentives, and a lack of support for the community-based organizations given charge of managing the funds. Although most schemes are designed to be self-sustaining with repayments funding new loans, in practice they are not, and the government has to continue to replenish their capital to keep them alive. Government-sponsored credit schemes compete with and sometimes undermine a diverse array of non-bank microfinance providers, all struggling to operate in a weak legal framework that works against their expansion, especially to rural areas outside Java and Bali. For the poor to have better access to finance the government needs to: (i) reduce the amount of public contributions to subsidized schemes, (ii) redirect public resources into building capacity of formal and community-based informal microfinance providers, helping them to reach more people, (iii) address the gaps in the legal and supervisory framework for microfinance, and (iv) promote links between non-bank microfinance providers and the formal banking sector.

Indonesia can Build upon its broad foundation of microfinance providers to expand access

Indonesia is rich in microfinance providers; they range from the Unit Desa of BRI regulated by the Banking Law and supervised by Bank Indonesia, to savings and loan cooperatives, village banks or Badan Kredit Desa, village level or Kecamatan financiers, and pawnshops. There are 54,000 financial outlets, with 45 million deposit accounts and 32 million borrowers. Unlike other countries, formal financial institutions rather than non-government providers dominate microfinance services.

Despite this range of microfinance providers, many Indonesians do not have access to micro-credit. A recent survey reveals that 50 percent of households may lack effective access to microcredit, and less than 40 percent have savings accounts, a number that is lower in rural areas. However, about a third of Indonesian households do not want to borrow, according to a survey (BRI, Asia Foundation, 2002). Another fifth are eligible to borrow and keen to do so but don’t know how, or are not served by outlets. Some are simply too poor to use credit without risking non-repayment, and their circumstances should be addressed through social assistance and grants, rather than financial services (see Figure 1). The objective of a policy promoting microfinance should therefore be to expand choice, not to deliver loans for all.

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These programs are costly. Direct fiscal costs comprise government spending on interest rate subsidies and capital injections into revolving fund schemes. Opportunity costs include the foregone revenues from SOEs’ spent on such programs, which would otherwise be available to the State as shareholder. The total costs of the larger of these program credit schemes come to about 1.2 percent of total central government expenditure and about 3.1 percent of Rupiah-financed development expenditure (Table 1).

Most of government spending goes to interest subsidies and capital, and too little to capacity building for the institutions managing the funds. In 2003 three trillion Rupiah, or almost eighty percent, went into subsidizing interest rates and topping up revolving funds (Table 2). A rather generous 18 percent of total program costs is administration—three quarters of which lands in the public sector. This leaves only

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**Public funds are not well spent**

Public spending in microfinance includes:
- Direct interest rate subsidies, such as on the Kredit Ketahanan Pangan (KKP) program;
- Fuel subsidy reduction compensation programs channeled through sector ministries into poorly-performing revolving credit programs, for example by the State Ministry of Cooperatives and SMEs and the Ministry of Marine Affairs;
- Deconcentrated funds of central ministries that are placed as revolving credit mechanisms, for example the Bantuan Langsung Masyarakat (BLM) model that absorbs 40 percent of the Ministry of Agriculture’s APBN; and
- A share of all State Enterprises’ (SOE) after-tax profits that is managed individually by these SOEs for outreach in the form of credit.

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2 The interest rate subsidy on this program was originally budgeted at Rp. 2.1 trillion in 2000 with additional resources in 2004. The interest rate subsidy covers the gap between the SBI and the 10.5% (in most cases) that is paid by the borrower, and has declined over this period as the SBI has fallen.

3 Recognizing that the BLM resources were revolving poorly within the targeted producer groups, which considered the funds more as charity than as a capital resource to be preserved, the MOA refocused the initiative for 2003 under the name ‘Pemberdayaan Masyarakat Agribisnis Melalui Penguatan Modal Usaha Kelompok’ but this has been more a change in name than in substance.
4.7 percent of public funds for building capacity within microcredit providers.

**Growth of non-bank microfinance providers requires a legal and supervisory foundation**

Many microfinance providers operate in legal limbo. Reform of laws regulating these providers was delayed during the financial crisis, and has yet to be completed. First, the Banking Law of 1992 required all LDKPs\(^4\) to be converted into formal banks (BPR) within five years, but implementation was delayed. Second, implementing regulations of the Banking Law require microfinance providers such as BKDs to have the same capital as the much larger BPRs. Third, the central bank law of 1999 removed BI’s mandate for regulating and supervising microfinance outside banks. And fourth, savings and loan cooperatives are regulated by a separate Cooperatives Law, which is also being revised to address the inadequate supervision framework.

<table>
<thead>
<tr>
<th>Program</th>
<th>Program administration and agency capacity costs, 2003, Rp. billion</th>
<th>Capacity building of microfinance provider, 2003 Rp. billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Pemberdayaan Masyarakat Agrbisnis Melalui Penguatan Modal Usaha Kelompok (PMAMPMK)</td>
<td>512</td>
<td>132</td>
</tr>
<tr>
<td>2. Kredit Ketahanan Pangan (KKP)</td>
<td>1</td>
<td>No specific budget</td>
</tr>
<tr>
<td>Program Kompensasi Pengurangan Subsidi Bahan Bakar Minyak (PKPS-BBM)</td>
<td>11</td>
<td>0.2</td>
</tr>
<tr>
<td>4. Pemberdayaan Ekonomi Masyarakat Pesisir (PEMP) (^a)</td>
<td>4</td>
<td>9%</td>
</tr>
<tr>
<td>Program Kemitraan dan Bina Lingkungan (PKBL) (^a)</td>
<td>Max. 3% of available budget (7.5)</td>
<td>Max. 20% of available budget (50)</td>
</tr>
</tbody>
</table>

| Share of total program administration and capacity costs | 26% |
| Share of total program budget allocation/costs (1,2,3,4) | 4.7% |

*Source: Septiana (2004)*

\(^a\) 2002; \(^b\) PEMP also requires a local budget (APBD) allocation to capacity building.

This incomplete legal and regulatory framework is limiting the growth and spread of microfinance providers outside formal banks. They are not formally permitted to provide savings services to the community, and credit services are difficult to expand without the support of savings. These providers are unable to borrow from banks, because banks are penalized for providing loans to organizations without formal legal status. Gaps in the legal framework also entice some microcredit providers to opt for the least regulated form for their organization, thereby putting their depositors at risk.

There have been attempts in the past few years to draft a microfinance law, as well as a revised cooperatives law, and legislation to establish a new supervisory capacity separate from BI. But the microfinance law, which is the Ministry of Finance’s responsibility within the administration, has not been a priority, and is still in draft. And the debate over the new supervisory agency (OJK) has focused on the larger financial institutions rather than on microfinance. So the legal limbo continues.

Beyond microfinance regulations and supervision, lack of title on land is a key constraint to people’s access to credit. Less than 25 percent of rural land parcels have formal land titles, compared to almost universal possession of land use certificates by farmers in China and Vietnam. Although land titles are not the only collateral in use for microcredit, they are very important, and lack of them limits access to credit. Analysis shows rural land certificates encourage people to borrow and invest, and so improve their incomes.\(^5\)

**Public support should shift to capacity building of microfinance providers**

The modest public support offered to capacity building for microfinance is usually restricted to simple bookkeeping. Government could do much more to support internal governance, growth planning, collection, bad debt management, and simple information management for credit

\(^4\) **Lembaga Dana Kredit Pedesaan** (LDKP) or Village Credit Funds, is a generic term for a variety of non-bank microfinance institutions that usually have offices at the *Kecamatan* level.

monitoring and administration. Even the insufficient service currently on offer is fragmented, provided by technical Dinas that have little expertise in sustainable microfinance, with inadequate monitoring, and little evaluation, distillation and replication of good practices.

A rapid shift in public sector programs towards greater capacity building assistance to microfinance providers would need to overcome government's own capacity constraints in providing such technical support to a large number of small organizations. Direct contracting with public procurement procedures to mobilize community-level facilitators is cumbersome, results in delays and a lack of continuity in facilitators working with revolving fund groups. Other mechanisms for simplifying the financing of technical assistance are being tested, such as putting the choice of facilitators and the linkage to technical assistance partners in the hands of the community groups. These approaches are showing promising results – the challenge is to find effective ways of scaling-up such mechanisms.

**Key opportunities for expanding access by the poor to financial services**

**Change the focus of public expenditures**, reducing direct capital transfers and interest rate subsidies and increasing attention to capacity building of microfinance providers:

- Assign to MOF the mandate for evaluating the viability of line ministries' capital transfer programs, with a view to substantially reducing them. MOF should also evaluate the effectiveness of the capacity building components implemented as part of these programs.
- Establish, under the leadership of MOF, a national strategy of support for sustainable microfinance services provision, with greater reliance on partnerships with non-government providers of training and institutional support.
- Increase public support and funding to develop effective approaches to capacity building of microfinance providers.

**Pursue supporting policies for improved access to microfinance services:**

- Finalize and submit to Parliament (DPR) a draft microfinance law.
- Facilitate links between the non-bank microfinance providers and the formal banking sector, for example, permit BKD to act as agents of commercial banks' savings programs, and to borrow commercially.
- Arrange for proper supervision of non-bank microfinance providers. Existing experience with delegated supervision of these providers (BKD by BRI, and LDKP and rural BPR by Provincial-owned Development Banks, BPD) should be evaluated, so that once a microfinance law is in place and an overall supervisory authority is established, focused testing and scaleup can be pursued.
- Pass the revised draft Cooperatives Law to provide a better framework for microcredit; including required external audits and supervision for savings and loan cooperatives.
- Accelerate land titling as a basis for collateral.