

# MICROFINANCE LINKAGES

## PROMOTION

With the Cooperation of  
Bank Indonesia  
and the  
U.S. Agency for International Development/Jakarta

Submitted to:  
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by

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**MICROFINANCE LINKAGES**

**PROMOTION**

**(MICROLINK PROJECT DESIGN)**

**DRAFT REPORT**

**UNDER COOPERATION BETWEEN**

**BANK INDONESIA**

**AND**

**UNITED STATES AGENCY FOR INTERNATIONAL DEVELOPMENT**

**Jakarta, September 1998**

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### Conclusions

**There is a commercial market made up of "sound rated" BPRs that need regular access to competitively priced commercial capital.** Demand for competitively priced private commercial bank financial products and services is already high and restricted access to these products and services is a barrier to private BPR growth. A commercially viable private BPR credit market and bank services market exists among the 600 sound rated BPR's identified in the MicroLinks Design survey. This market for financial products and services will grow as the proposed MicroLinks channel is implemented and greater numbers private BPR's receive assistance through STFIF and requalify as sound units.

**Most private commercial banks lack the experience and staff to provide competitively priced financial products and services to "sound rated" BPR or to their sub-borrowers.** Few branch loan officers of private commercial bank have succeeded in developing an active portfolio of private BPR clients. Untrained in evaluating and supervising loans to small financial institutions that providing micro and small finance lending and savings products, branch account officers choose to handle larger retail oriented commercial clients. BPR rarely compete directly with commercial bank branch sub-borrowers.

**The "sound rated" BPR market represent a specialized commercially viable lending market with credit volumes and interest spreads that will support the development of Second Tier Financial Institution (STFI).**The 600 of the 1284 privately owned BPR's form a viable provincial level concentration and population to generate a feasible business of developing a specialized professional channel to take credit products and services down market to sub-provincial outlets,

**Commercial banks and insurance companies are prepared to consider investing jointly in the MicroLinks designed Second Tier Financial Institution STFI model.**

Commercial banks are attracted to "founder status" as owners for three reasons. Ownership of a professional operated channel that provides a link to 1284 sub-

provincial points of sale for their financial KUK products and services. Another attraction is the right of founders to use the channel to market their own brand name savings and loan products to BPR owners. Thirdly the founders logo becomes part of the STFI brand logo and this logo appears on every participating private BPR.

**Commercial interest in the Second Tier Financial Institutions (STFI) is also linked to the MicroLinks design to scale-up the volume of annual credit disbursements to between Rp 3-5 Trillion** Introduction of a new institutions owned by formative large private foreign and local commercial banks and insurance companies presents a opportunities beyond the SFID focus of the MicroLinks design team. Other potential STFI products including high value high volume corporate accounts like pawn shops, credit unions and buying of receivable are as important to the success of the MicroLinks design as establishment of the Small Financial Institutions Departments (SFID). Driving this need for higher value and higher volumes products is Bank Indonesia regulations requiring commercial banks to place 22-25% of new portfolio lending in KUK investment or pay fines.

**Strong government sector supports exists for increased participation of the private financial sectors initiative to develop a professionalized channel to move products and services to sub provincial small financial institution markets.** The MicroLinks Design Team interim and final exit meeting with Ministries of Finance, Planning and Bank Indonesia have been highly supportive of the STIF design. Behind the supportive endorsement of the design the government is prepared to assist the STIF development by written authorizations removing all the regulatory and legal issues presented by the design team.

**Improved management supervision is the single most important investment activity USAID and Bank Indonesia can now make for the medium and long term sustainability of the privately owned BPR's.** It is the opinion of the MicroLinks design team that form an Indonesian national and US Government BI-lateral development prospective there is no other investment that competes with proposed improved management supervision of the private owned BPR

**USAID will need to continue to play a role of the respected outside broker and catalyst positioned to take the leadership to bring together founder private commercial banks as owners of the MicroLinks design concepts.** The USAID logo and technical assistance will continue to be required to facilitate the development of MicroLinks. The follow-up brokering activities need to expand the vision of the design team focus beyond SFID to include other SFI markets and services that will bind the consortium together. These additional commercial concepts are necessary to develop because of the marketing power and significant strategic opportunities presented by successfully joining forces of major international and local banks in a multi finance company environment. Some of these opportunities to be explored will become evident only when the individual founders are identified and their comparative advantages will present themselves. The opportunity made possible by the joint venture company will include foreign banks sharing risk and the use of local banks branch infrastructure and local banks ability to cooperate with foreign banks with off-

shore experience in development of new SFI domestic products and services. The proposed follow-up technical assistance team will need to broker these ideas to potential MicroLinks founders to assure the opportunity of the expanded vision for the multi-finance company becomes a living part of the design.

## **Recommendations**

Recommendation for follow-up short term technical assistance to facilitate founders ownership and implementation of the MicroLinks program .

Timely USAID facilitation is recommended to promote the MicroLinks design vision and provide the energy and leadership to assist the potential stake holders as they take steps toward accepting ownership and financial responsibility for the concepts. Ideally, this intervention should start by mid November after parties have had a chance to study the design team documentation and talk among themselves. However the holidays would interrupt the process and early January may provide an uninterrupted window to close the deal with stakeholders. ( see Annex 1: Phase II MicroLinks Terms of Reference)

Follow-up long term technical assistance recommendation.

A USAID long term technical advisor is proposed to assist the STIF Managing Director in start-up operations of STFI, SFID and STFIF. The initial years of start-up operations are critical to getting the structure, procedures, systems, policies, products and programs correct. Senior local talent is plentiful at this time of crisis and it is anticipate that founders will find an entrepreneurial local professional from the banking industry to grow STFI, SFID and STFIF divisions. An experienced and entrepreneurial long term technical assistance sponsored under the USAID logo will be a honest broker in assisting the ethnically, socially and culturally different joint venture partners to work together and gain confidence and trust in each other. ( See annex 11 MicroLinks LONG TERM TECHNICAL ASSISTANCE Terms of Reference)

### **Recommended second quarter 1999 timing for implementation of the project.**

Project start-up could occur as early as April or May of 1999 after the successful conclusion to the pre-investment short term technical assistance program. This would likely suggest the first loans would be marketed in the SFID channel in first quarter 2000.

## **Recommendation for keeping STFIF from becoming labeled a one donor program.**

A missed opportunity would occur if the follow-up brokering team were unable through indirect means to get foreign governments of foreign banks and insurance STFI founder companies committed in taking ownership along with USAID in the development of the organization. This is one of the items identified in the draft terms of reference.

## **Introduction**

For more than thirty years prior to its current deep economic crisis, Indonesia enjoyed remarkable economic progress. With average annual GDP growth of around 7.5% annually, both the real and financial sectors of the economy experienced substantial development.

Despite the deep flaws in operation and supervision exposed by the current economic situation, Indonesia's banking sector has served as a catalyst across the size spectrum of Indonesian enterprises. Not only have conglomerates and multinational corporations been financed by the nation's banks, millions of low-income households have also benefitted from increased access to financial services caused by the growth of the financial sector. Lending to small and micro enterprises has clearly assisted Indonesia in maintaining broad-based economic development, and the nation is recognized as a world leader in commercial micro finance.

The so-called ANew Paradigm@ (now in its third decade) of micro finance holds that micro finance institutions can benefit low-income households on a large scale by emphasizing commercial sustainability and fast, simple, convenient access to basic banking services. Within the New Paradigm, micro finance is also often seen as an important tool in poverty alleviation.

No other nation approaches Indonesia in the scale of its commercially successful micro finance operations. While the Unit system of Bank Rakyat Indonesia is the best known institution, other examples include the century-old Badan Kredit Desa, the Badan Kredit Kecamatan of Central Java, and the Lembaga Perkreditan Desa in Bali.

It is worth noting that virtually all the success stories in Indonesian micro finance involve state-owned institutions. Despite providing the majority of bank credit in the country, private commercial banks are far less prominent in micro and SME finance in Indonesia.

## **SME/Micro Lending and the Kredit Usaha Kecil (KUK) Requirement**

In 1990, the Government of Indonesia decided to institute what became known as the KUK (Kredit Usaha Kecil, or Credit for Small Business). Introduced as part of a package abolishing most subsidized central bank liquidity credits for small business, the KUK quota was intended to demonstrate the government's commitment to the idea that small businesses should receive a substantial share of commercial bank credit. Though instituted without a formal analytical basis, measurement of bank compliance with the KUK requirement provides useful information on trends in bank lending to small enterprise in Indonesia.

(Recheck statistics on KUK lending; 9.6% may be wrong, and the figures don't clearly differentiate between disbursement and outstanding)

While there is little economic harm in any individual bank's failure to meet the KUK requirement, private banks' general non-participation in the market for SME finance may have much more significant consequences for the economy over time. Few private banks have invested in acquiring the knowledge, systems, and experience to engage in effective SME and micro lending, nor have many banks targeted this market for future development. For many private banks, meeting the KUK requirement may be an important spur in considering the market for SME/micro credit.

## **The New KUK**

In April 1997, the Government of Indonesia modified the KUK requirement to emphasize the flow of loan disbursement rather than the stock of outstanding commercial bank loans. The old requirement of 20% of the banks' loan portfolio was changed to up to 25% of the value of loans disbursed. At the same time, the definition of a small enterprise was altered and the maximum KUK loan size was increased to Rp. 350 million.

Banks may meet the KUK requirement in several different ways: via direct lending to small or micro enterprises, through joint finance or assumption of small/micro loan portfolios (including the underlying loan risk), by participating in small business linkage programs, or by lending to Bank Perkreditan Rakyat, or BPRs.

Bank Perkreditan Rakyat (BPR)

BPRs, or Apeople=s credit banks,@ are the smaller of the two types of bank recognized in Indonesian banking law. New BPRs are generally restricted by law from operating in core urban areas. Few private BPRs are genuinely rural, however, with most located in suburbs or peri-urban areas surrounding large cities.

The Indonesian banking deregulation introduced in October 1988 (called PAKTO=88) formally established the category of privately owned BPRs and greatly eased requirements for opening new banks and branch offices for both commercial banks and BPRs. For the next several years, the number of commercial banks, BPRs, and their offices grew rapidly. By March 1998, there were 9379 BPRs, of which 1,284 were privately owned. By comparison, the number of bank branch offices grew by 200% during this period. This latter figure does not include BRI Units, of which there were over 3,700 by June 1998.

The rapid growth in the number of BPRs has not been associated with a substantial share of BPR loans in the total KUK portfolio of the banking system. For example, as of March 1998 the total KUK credit outstanding from commercial banks was Rp 65.8 trillion, while BPRs= KUK was Rp 2.2 trillion, only 3% of that from commercial banks. This low percentage stemmed partly because many BPRs suffered from insufficient capital, but it also highlights the BPRs limited capacity for lending.

At the same period, commercial banks had total credit outstanding of Rp 550.5 trillion. The above figures show that commercial banks only channeled some 13% of their portfolios to KUK lending. This figure is sharply lower than in previous years, due mainly to the effect of the depreciating rupiah on the foreign currency-denominated loans of Indonesian banks. Prior to the current crisis, the banking system had slightly more than 20% of its loans in KUK. Out of Rp 65.8 trillion of their KUK lending, only 0.7% went to BPRs.

Under the old KUK rules, commercial banks could meet their KUK requirement by purchasing the debt instruments of banks with “surplus” KUK lending in their portfolios (these instruments were known as SBPU-KUK). These instruments usually paid around 1% below the normal rate for comparable obligations, resulting in a more or less risk-free cost of compliance of about 1%. Under the new KUK rules, this method of compliance is no longer allowed. The financial penalty of 2% has raised the cost to banks of not meeting the KUK requirement, but perhaps not sufficiently to cause many banks to want to take the risk of lending in an unknown market. Many private commercial banks will still feel the need for an intermediating institution before they are comfortable about accepting the risk of the unknown.

### **The Potential Contribution of BPRs in a Broad-Based Economy**

Because they tend to specialize in KUK lending, lending to BPRs is one possible solution to the banks' problems. The existence of strong private BPRs also helps improve local access to financial services by providing choice, flexibility, and some measure of local competition to the larger state-owned institutions engaged in true commercial SME and micro lending. Because of their relative flexibility, private BPRs may also have the potential to serve as sources of innovation

## **0.2. PURPOSE**

The purpose of this task order is to design a national scale activity in microfinance development. The activity aims to support a linkage mechanism between supply of small credit funds and demand for capital by the micro and small business sector.

## **0.3. STRATEGIC OBJECTIVES**

To improve the domestic and economic competitiveness and increase access to financial markets by providing a linkage mechanism between the supply of small credit funds and the demand for capital by micro business.

## **1.4. BENCHMARKS OF TASK ORDER**

In order to accomplish the strategic objective, the design team completed the following benchmarks in the task order:

- (1) Completed a review of the nature and magnitude of micro and small credit demand, and the nature and characteristics and effectiveness and efficiency of BPRs. (Chapter 1)
- (2) Completed a review of the problem of KUK implementation by commercial banks. (Chapter 11 Main Report)
- (3) Completed a roles and functions needed to bridge the gap between demand and supply of small and micro credit.

ons on functions for the  
Second Tier Financial Institution.( Business Plan Annex10)

- (4) Completed recommended for initial scale of operation of Second Tier Financial Institution and a description of its operation once it is

able to operate at full capacity and magnitude of costs. (Business Plan Annex 10)  
(Financial Model Annex 10)

- (5) Completed a recommended ownership structure of Second Tier Financial Institution. (Memorandum of Understanding Annex 8)
- (6) Description of financing by entity from potential sources. (Financial Model Annex 10)
- (7) Recommended roles for USAID and/or other donors. (Terms of Reference STTA Annex 7)
- (8) A design for the implementation and a Business Plan for Second Tier Financial Institution. (Business Plan Annex 10)
- (9) A detailed work statement and budget for a Second Tier Financial Institution technical assistance from USAID. (Terms of Reference Annex 7)

## **5.1. CURRENT ISSUES**

The timing of the MicroLinks Design Team assignment corresponds with the deepening financial crises in Indonesia. Also many of the original government planners and supporters of the project have moved on to new positions. The Team focused its efforts over the first weeks on reintroducing the program and recounting the history leading up to the Design Team Terms of Reference and Scope of Work. The Team has completed the Scope of Work thanks to the support of Bank Indonesia Staff in UBPR and UK which provided office space and seconded staff to assist in the collection and analysis of material. The Team was also greatly assisted by help from USAID Staff that provided support in discussing major issues and providing suggestion on contacts and research materials. Our thanks to all of these busy people for their support and their time.

The banking crisis has raised many questions about the ability of any financial institution to operate profitably under the current conditions. The models built to test our proposed program have used assumptions that were true when the economy reflected more rational economic rates. Our proposals assume that if the program were approved now it would take over a year to

implement the start-up activities. It is hoped in a years time a more reasonable economic climate will exist for banks and borrowers alike.

## **Topology of BPRs Defined by Ownership Size Distribution and Soundness and ,Supervision**

This topology information is important to grasp an understanding of the relative scale of publicly and privately owned and managed BPRs. Also the topology of the BPRs will unlock some of the important characteristics of this network of small financial institutions and how they contribute to communities and villages across Indonesia.

The Figure 1 provides the topology of BPR=s over the following parameters, owner type, supervision agency, asset size and soundness. The Design Team reports on size, location and soundness parameters for Bank Indonesia supervised privately owned BPR only.

Of the total BPR population of 9,379 units there three classes, BKD (Badan Kredit Desa), LDKP (lembaga Dana dan Kredit Pedesaan) and BPRs (Bank Perkreditan Rakyat include Bank Pasar).

- 5,346 units of BKDs are owned by local Government and supervised by BRI (Bank Rakyat Indonesia). According to the law all are located in Java and Bali;
- 1,848 units of LDKPs are owned by provincial government, supervised by BPD (Regional Development Banks in each province);
- 2,386 units of BPRs are licensed by the Ministry of Finance and supervised by BI. This population consist of 902 BPR-LDKPs units and 1,284 private owned BPRs

Figure #1 Sieve

Figure 2 Map

## A Profile of 1284 BI/BPR

Private BPRs has the highest percentage of soundness when compared with LDKP and BKDs. The ration for soundness of BI/LDKP=s is one out of every three and for BI/BPR=s it is one out of every two that is sound. Table #1 helps illustrate the relationship between size of private BPR and its probability for being sound.

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**TABLE 1**

### NUMBER OF PRIVATE AND SOLVENT BPRs BY TOTAL ASSET SIZE per 31 March 1998

| CATEGORY<br>OF BPRs                 | SMALL SIZE | MEDIUM<br>SIZE | LARGE SIZE | TOTAL   |
|-------------------------------------|------------|----------------|------------|---------|
| PRIVATE<br>BPR                      | 812        | 359            | 113        | 1,284   |
| SOLVENT<br>BPR                      | 356        | 212            | 69         | 637     |
| PERCENTAG<br>E<br>OF SOLVENT<br>BPR | 43.84 %    | 59.01 %        | 61.06 %    | 49.61 % |

Source : Bank Indonesia

The larger the private BPR gets the more likely it will be sound. This data supports the concept of economies of scale. The larger and more establish companies are, the more likely they will have been older and wiser and sound.

### **Profile of Small Size Private BPRs**

These BPR have a asset range below Rp 1 billion with average total assets around Rp 500 million. There are a total of 812 of these units of which 356 unit are solvent From the Field Sample Survey we found an average of 868 clients have loans with an average value of Rp 1 million . In our survey 71% of small private BPRs had borrowed an average of Rp164 million from commercial banks.

### **-Profile of Medium Size Private BPRs**

Medium size BPR=s have a total asset value ranging from Rp 1 Billion to Rp 3 billion with average total assets of around Rp 1.60 Billion. There are a total of 359 of these units of which 212 unit are solvent From the Field Sample Survey Profile of private BRPs in this asset range we have found an average of 993 clients have loans with an average value of Rp 1.1 millon . In our survey 62% of medium size private BPRs had borrowed an average of Rp168 million from commercial banks.

### **Profile of Large size Private BPRs**

Large size BPRs focused on units which have a total asset value ranging from Rp 3 Billion to Rp 60 billion with average total assets for the group calculated at Rp 7.5 Billion. There are a total of 113 of these units of which 69 unit are solvent. From the Field Sample Survey Profile of private BPRs in this asset range we have found an average of 2107 clients having loans with an average value of Rp 3 million. In our survey 83% of large size private BPRs had borrowed an average of Rp1.7 billion from private commercial banks.

The time series data below shows the number of BPRs increased rapidly after Bank Indonesia issued its October 1988 bank deregulation package called "PAKTO'88". (Figure 3

### **FIGURE 3**

Source : Statistical Data of Bank Indonesia

LDKPs show here are decreasing because they are converting status from being traditional LDKP supervised by provincial development banks to BPR-LDKP licensed by Ministry of Finance and supervised by Bank Indonesia..

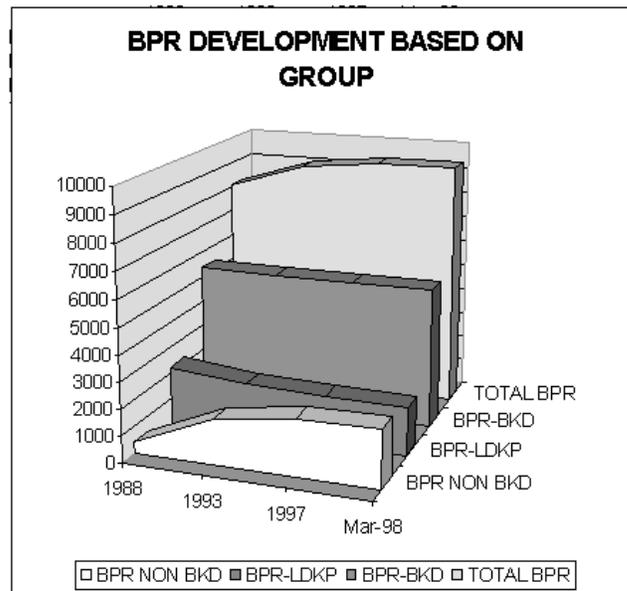
## Analysis of Sources of Funds by BPR Type

Table 2 also shows a total asset value for all BPRs at Rp 3,472 billion where 84% of the asset value is supervised by Bank Indonesia and 10% of asset value is supervised by the provincial development banks and 5% of the asset value is supervised by BRI.

TABLE 2

### SOURCES OF FUNDS OF BPRs, BKDs AND LDKPs (In billion Rupiah)

#### SOURCES OF FUNDS



|                       | <b>BPRs*</b> | <b>BKDs**</b> |     |
|-----------------------|--------------|---------------|-----|
| Saving                | 633,175      | 22.8          | 88  |
| Time Deposit          | 966,334      | -             | 121 |
| Interbank Loan        | 455,096      | 8.1           | 74  |
| Internal & Other Loan | 85,539       | .6            | -   |

|                  |   |       |       |
|------------------|---|-------|-------|
| Capital          | 712,605                                 | 154.  | 23    |
| Total Asset      | 2,944,157                               | 185.6 | 343.0 |
| * March 1998     | Statistical Data <u>Bank Indonesia</u>  |       |       |
| ** December 1996 | <u>BRI Statistical Data</u>             |       |       |
| *** June 1995    | <u>Provincial Development Bank Data</u> |       |       |

*NOTE: The Design Team was unable to find data from all supervision agencies covering the same period. The data reflects accurately the relationships and magnitude of values within and between BPR types*

Table 3 below illustrates that the major sources of funds for all BI/BPRs and LDKPs are customer saving and time deposit. BKDs major source of funds comes from their own equity.

The value of bank lending and savings and time deposits for BI supervised BPRs as of March 98 is Rp 455,000 and Rp 1,599 billion respectively. In percentage terms this equals 15% and 54 % respectively of total assets. Time series data will show interbank lending to be of increasing importance to growing these types of BPRs. Private commercial banks provide the major source of interbank lending for 1284 or private BI/BPRs. Provincial development banks provide interbank lending to the 904 BPR/LDKP included in the group of Bank Indonesia supervised BPRs.

The value of bank lending and savings and deposits for LDKPs is 74 Rp billion and RP 209 billion respectively. In percentage terms this equals 21% and 58% respectively of total asset. Provincial development banks provide the major source of interbank funds for LDKPs.

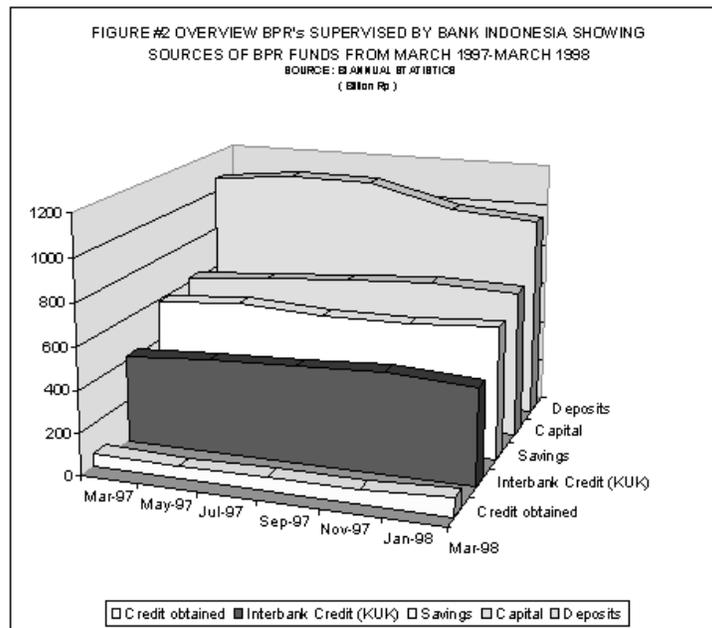
The value of bank lending and savings and deposits for BKD is Rp 8.1 Billion and Rp 22.8 billion respectively. In percentage terms this equals 4% and 12.2 % respectively of total assets. BRI is the source for most BKD interbank borrowing

Channeling KUK funds from Commercial Banks (CB) to BI/BPRs in March equaled 15.45 % of total asset or only 0.7 % of total KUK funds provide by CBs.

Figure 4 shows time series data on sources of BI/BPR funding from March 1997 to March 1998. Over this time period the BI/BPRs have seen

their highest ever growth following the overall general economic conditions. The drop in deposits in the last quarter is as a result of the financial crisis and the flight of deposits from BPRs to commercial bank where government has decreed a guarantee on depositors.

**FIGURE 4**



**Source : BI Annual Statistics**

Private bank borrowing in the December to March 98 quarter have leveled and begun to decline. This

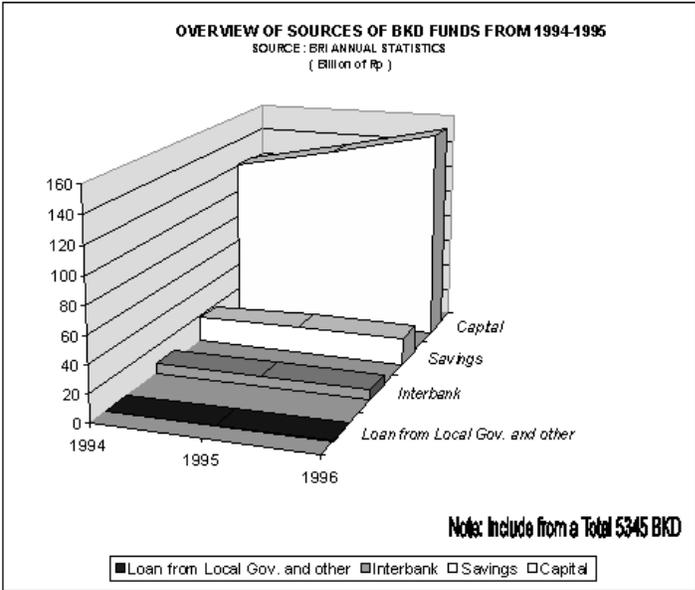
represents the contraction in overall commercial bank lending to all commercial borrowers. The anticipated trend for June 1998 is for further erosion in interbank loans. In our interviews with BPR owners we discussed the reduced savings, deposit, interbank lending issues and their impact on near term operation strategy. BPR owners said this would have a impact on lending to any new borrowers. The Design Team

anticipates that BI/BPRs will for the short-term place funds in interbank 60-70% investments rather than in new lending.

### Background and Overview of BKD=s from a Sources of Funds Prospective

BKD=s are specialized BPRs found only on Java and the Island of Bali. They are generally located near or in local government offices. The often are open for business only once a week. A BKD accountant may be employed to operate up to 3 or 4 different units. The Ministry of Finance has directed that no new licenses for BKD will be issued. BRI is paid by Bank Indonesia to supervise the 5346 units.

FIGURE 5



This time series data in Figure #5 provided a graphic view of the strong equity base of BKDs. These organization do not have an aggressive savings and deposit mobilization history. BKD generally do not require interbank finance. When interbank finance is required BRI is in the best position as supervisor to assist these organizations.

## **Background and Overview of LDKP from a Sources of Funds Prospective**

LDKP are located in most of the 27 provinces in Indonesia. There are 1848 LDKP supervised by provincial development banks and another 902 which have Ministry of Finance licenses and supervised by Bank Indonesia. These organizations are sometimes owned jointly with local government or are wholly owned by the provincial government. Operation and institution quality vary between provinces. Often LDKP act as branches to provincial development banks and all have saving and deposits products as well as providing loans. LDKP were directed by the Ministry of Finance to become qualified to be licensed financial institutions and come under the supervision of Bank Indonesia. One out of every three has qualified under this program. Figure 6 provides a snapshot of sources for LDKP funds in 1995.

### **FIGURE 6**

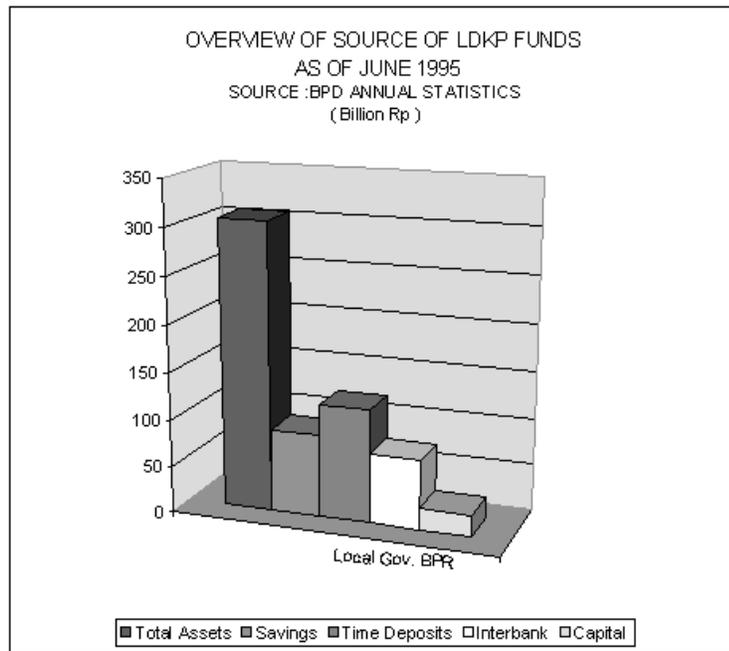
In percentage terms LDKP are the most efficient mobilizers of savings and deposits. Because of their ownership structure they have access to interbank lending facilities through the provincial development banks credit window. Likewise the LDKP look to

the PDB to provide treasury functions. The PDB also provided training and logistic support to LDKP as a part of the larger development functions that some provincial governments play. KUK participation in LDKP asset base is very small. BPDs (Regional Development Banks) is primary channeler of sources.

**BPR overview on uses of funds**

Figure 7 reflects summary time data on how BPRs, BKDs and

LDKPs use the funds they receive in the form of savings, deposits, interbank loans and owners equity.



About 74.93 % of BI/Bars total asset are invested in loan portfolio. About 56.21 % of BKDs total asset are invested in their loan portfolio. LDKPs have about 88.62 % of total asset in outstanding loans. BKDs have in BRI interbank deposits some 35.67 % of their total asset. Absent from this analysis is any data on quality of these LDKP and BKD portfolios.

**TABLE 3**

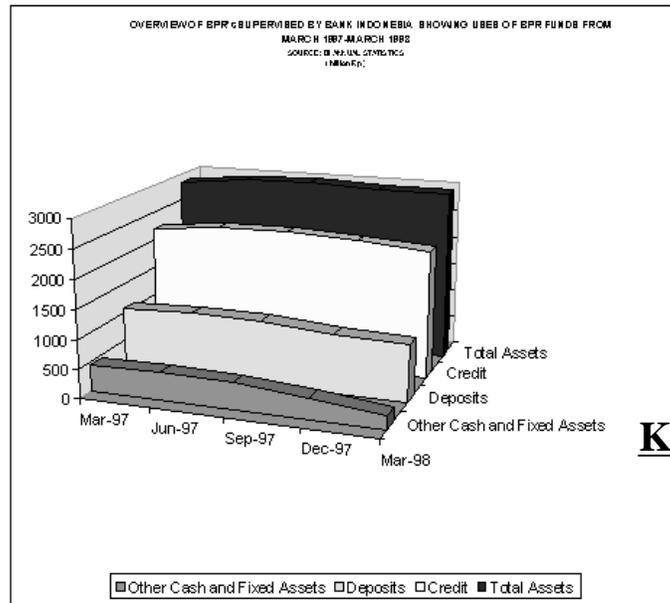
**USES OF FUNDS OF BPRs, BKDs AND LDKPs**  
**(In billion Rupiah)**

| <b>USES OF FUNDS</b>   | <b>BPR*</b> | <b>BKD**</b> | <b>LDKP***</b> |
|------------------------|-------------|--------------|----------------|
| LOAN                   | 2,206       | 104          | 304            |
| INTERBANK<br>DEPOSIT   | 456         | 66           | 39             |
| CURRENT &<br>FIX ASSET | 282         | 15           | -              |
| TOTAL ASSET            | 2,944       | 185          | 343            |

\* March 1998 Statistical Data Bank Indonesia  
 \*\* December 1996 Statistical Data Provincial Development Banks  
 \*\*\* June 1995 Statistical Data BRI

BI/BPRs have on interbank deposit 15.5 % or Rp 456 billion as of March 1998. This value almost exactly corresponds with the value of interbank loans Rp 455 billion recorded in same March 1998 report. This at first glance could be mistaken for back to back lending on the part of commercial banks. This figure represents the total of 2386 banks separate deposit and lending decisions and is not likely to be the same banks involved in generating these statistics..

**FIGURE 7**



## K U K Implementat i o n o f Microfinance and Credit

### Scheme For Small Business

Government of Republic of Indonesia through Bank Indonesia has been implementing KUK microfinance and small business credit: programs over the years through state and private banks. The MicroLinks program is reviewing one special kind of KUK program which require commercial banks to invest a minimum of 25% of their lending portfolio in small loans. Readers should be aware of other types of subsidized government KUK programs, which use either government money or a blend of government and commercial bank funds. Below are examples of subsidized KUK programs operated by Bank Indonesia through commercial banks.

#### a. Kredit Usaha Kecil (KUK)

Small Business Loan (KUK) as continuation of KIK and KMKP (Small Investment Credit & Permanent Working Capital Credit). The differences between two credit scheme (KUK and KIK/KMKP) are as follows:

- KIK/KMKP has facilitate to use KLBI (liquidity credit of Bank Indonesia 65 %) channeling to commercial banks (using their owned financial resource 35 %). KUK has no facility from BI, all source of funds are come from commercial

banks its self.

- BI determined rate of interest of KIK/KMKP for commercial banks (9 % rate of BI and 12 % rate for end users). In case of KUK, commercial banks have authority in deciding their rate of interest to be implemented.

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b. Kredit Usaha Tani (KUT)

Credit to Farmers (KUT) is used to finance paddy and secondary crop intensification, and certain horticulture commodities. Special loan for agriculture sector, BI providing liquidity credit as source of funds channeling to commercial banks with rate of interest of 3 % and back charge to KUD (village unit cooperative) of 9 % and KUD channeling this credit to farmer with rate interest of 14 % pa.

c. Kredit Kepada KUD (KKUD)

Credit to Village Unit Cooperatives are used to finance the procurement of rice, food crops, cloves, fruits, vegetables, ginger, fertilizer and horticulture commodities. This credit can also use to finance KUK investment in agribusiness sector. Source of funds of KKUD are came from KLBI (65 %) and the rest (35 %) self financing from commercial banks. BI charge 3 % rate of interest and CBs provide 16 % rate of interest to KUDs (as end users).

d. Kredit Kepada Koperasi Primer Untuk Anggota (KKPA)

The purpose of this credit is not only to provide capital for the primary cooperative but also for the cooperative members to expand their businesses and to increase productive activities. The activities are in food procurement, industry, trade and services. BI provide a 3% rate for a 65% liquidity credit which commercial banks contribute and additional 35 % and pass it on to primary cooperatives at 14 % and primary cooperative will charge 16 %

to the members. To accommodate the development of certain sectors, the scheme has been expanded as: (i) KKPA-TRI, used to finance sugarcane intensification; (ii) KKPA PIR-Trans, used to finance farmers transmigrate in East Indonesia Region through partnership pattern with some medium/large companies; and (iii) KKPA TKI, used to finance Indonesian labor who work abroad.

e. Kredit Kepemilikan Rumah Sederhana/Sangat Sederhana (KPRS/KPRSS)

Low Cost Housing Credit used to help the neediest social groups, especially homeless, to own a house. BI provided liquidity credit 50 % (for KPRS) to 75 % (for KPRSS and ready to build land/KSB) with charge about 3 % (for KSB and KPRSS), 4 % (for 18 m<sup>2</sup> house/T 18 and 21 m<sup>2</sup> house/T 21), 9 % (for 27 m<sup>2</sup> house T 27 and 36 m<sup>2</sup> house/T 36) to commercial banks, and CBs will charge 8.5 % (for KSB and KPRSS), 11 % (for T18 and T21) and 14 % (for T27 and T 36) to the clients/end users.

f. KIK Pasca Konversi PIR-Trans

Small-Scale Investment Credit after Conversion of Credit for Public Nucleus Estate-Transmigration, the purpose of this credit is to finance farmers transmigrate in East Indonesia Region through a partnership pattern with some medium/large estate companies. At first, credit is given to the medium/large estate company, as anucleus, to develop plantation. After the estate is almost ready for harvest, the credit is converted to farmers transmigrate who worked in plantation. By receiving the conversion credit, the farmers can own a part of the plantation and benefit from it.

## **MicroLinks Connection to the KUK Programs**

The type of KUK program which MicroLinks focus on uses strictly commercial funds which commercial banks regulators require are in loans of small sizes. Many commercial banks lack the infrastructure and experience to administer small loans. These bank include foreign bank, corporate banks and foreign exchange banks. When the 1992 banking act changes were completed there were only two kinds of banks, commercial banks and rural banks. The realestate, foreign exchange, project

and corporate specialty banks all became overnight commercial banks. Retail banks and speciality banks began to compete in each other's core business. The 25% KUK ruling impacted hardest on the specialty banks because they had very little experience handling small business and retail loans. Meeting the KUK program requirements has been easier for the older retail banks with branch networks and staff experienced in handling small retail and commercial lending. The MicroLinks Design Team survey of commercial banks confirm that KUK will remain a long term issue for specialty banks. These banks are the most likely target for ownership in the MicroLinks program.

Since April 1997, BI has implemented a new policy on KUK credit scheme for commercial banks. The new program eases the regulations on these “specialty banks”. Table 5 below reviews the changes in the KUK law now in affect.

**TABLE 5**

**REVISED ON KUK POLICY STRATEGY**

|                                       | <b>OLD POLICY<br/>(PAKMEI 1993)</b>                              | <b>NEW POLICY<br/>(APRIL 1997)</b>  |
|---------------------------------------|--|---|
| <b>Credit Ceiling</b>                 | Rp 250 million   | Rp 350 million  |
| <b>Small Scale Business Criterion</b> | Total asset maximum of Rp 600 million (exclude building and land | <ul style="list-style-type: none"> <li>- Networth Rp 200 billion (exclude land &amp; building)</li> <li>- Maximum sales turn over Rp 1 billion a year</li> </ul>  |
| <b>Minimum Requirement</b>            | 20 % credit portfolio  | <ul style="list-style-type: none"> <li>- 22.5 % net credit expansion for banks already cover 20 % credit portfolio</li> <li>- 25 % net credit expansion for banks not accomplish yet 20 % credit portfolio</li> </ul> |
| <b>Reward and Penalty</b>             | <b>Reward</b><br>Additional credit                               | <b>Reward</b><br>- Incentive of 0.5 %   |

value of 0.25 for an excess of 1 % each with maximum 5 %

**Penalty**

Credit deduction value of 0.25 for a lack of 1 % each maximum 5 % will be accounted to the performance and soundness of banks

for reaching of 30% credit expansion

- Incentive of 1 % for reaching of 30-40 %
- Incentive of 1.5 % for reaching of more 40 % credit expansion

**Penalty**

2 % penalty for each lack of credit

Banks visited in the survey welcome these new rules. They increase the size of loan eligible for KUK and they establish a certainty on the penalty to be extracted if compliance is not met. Some banks we talked with were not prepared to risk lending to micro or small groups of 1 borrowers and were happy to pay the fine and consider the payment as part of the cost of doing business in Indonesia. Other banks however feel committed and morally obliged to go down market with their bank products.

One outcome of the current crisis is the slowing of KUK loans to BPRs. Bank Indonesia has taken note of two significant and separate events simultaneously impacting on the rural banks. The first comes as a result of the June regulations issued by Bank Indonesia which guarantees savings and deposits put into commercial banks. Savers and depositors in rural banks are moving their money to safer commercial bank. The BRI Unit Desa system recorded a one month increase in savings and deposits of Rp 1 Trillion. The second event to impact rural banks is the falling off of KUK as a source of rural bank funding. This section of the report will help to put this second event into sharper perspective.

**Introducing the KMK Program**

To address the rural banking working capital credit squeeze Bank

Indonesia announced the KMK program in Circular Letter BI No. 31/3/UK Dated June 9, 1998. This BI implemented credit scheme called "Kredit Modal Kerja" (working capital credit) will channel (Rp 700 billion) to the solvent and sound BPRs . This program targets the demand for credit in the micro and small business sector in Indonesia. The scheme charges BPRs 15% interest rate and the BPRs charge a maximum 30% to sub-borrowers.

The Design Team discussed this program with BPR owners in our sample survey. The reactions were mixed. Most BPRs welcomed the 15% credit but viewed the 30% ceiling as a problem. Many BPR normally work on larger spreads than 15%. The other major issue raised was the operational problem of selecting which sub-borrowers would get the KMK funding and which would not. Many BPR owners indicated they would not use the program. The fact remains that this fund will have an eventual impact on KUK. Our analysis suggests that larger BPRs will require in excess of the Rp 500 million yearly ceiling on KMK program borrowing. Smaller BPRs may not seek KUK interbank loans as a result of the KMK program.

The Design Team takes a negative position on this KMK subsidized credit program. This is a backward step from the prospective of getting BPRs off subsidies and focus on intermediating commercial rate money. The Team understands the motivation for developing the program for the short run BPR credit squeeze but the long run impact could damage relations with sub-borrowers

## **IMPLEMENTATION OF KUK AND THE TRENDS OVERVIEW**

### **A. Disbursement of KUK Funds**

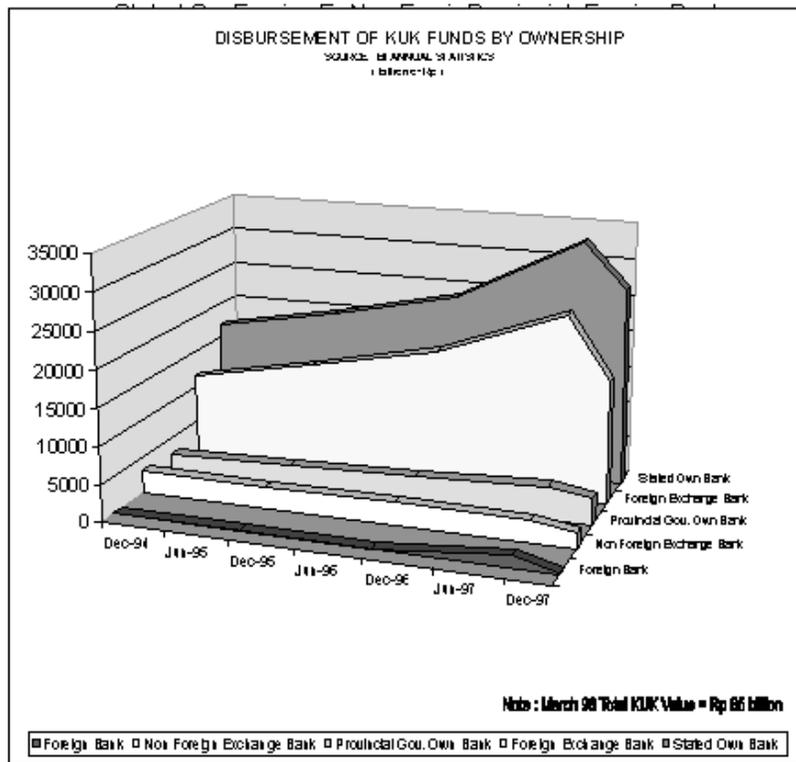
Bank Indonesia KUK policies impacts on all BI supervised banks including those banks owned by local government, provincial government and central government; national private. foreign company owned. Total KUK disbursement in March 1998 is Rp 65.8 trillion.. Figure 8 shows KUK disbursement according to the ownership of banks:

### **FIGURE 8**

- State owned banks take part 49.2 % of total KUK;
- Private owned banks take part 40.5 % of total KUK;
- Provincial government owned take part 6.5 % of total KUK;
- Foreign banks take part 3.8 % of total KUK.

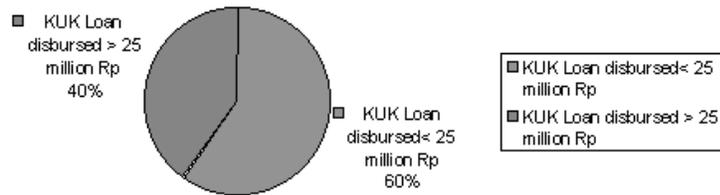
**b. Value of Disbursement of KUK base size of KUK Loan**

Figure 9 illustrates March 98 KUK data showing 60.1 % of KUK loan disbursement is to customers spending Rp 25 million or less. These would include consumer loans for household items, cars, and motorbikes. This credit is associated with "consumptive credit". Customers can use this kind of credit for "anything", banks will not ask the purpose for the credit. A total of 16.7 % of KUK disbursement went to customers requiring Rp 25 million to Rp 100 million. The remainder around 23.2 % were loans extended to the customers between Rp 100 million and Rp 350 million. These last two groups of loans would be monitored by BI bank supervisors to assure they meet the criteria of business loans.



**FIGURE 9**

**LOAN VALUE OF KUK DISBURSEMENT BY COMMERCIAL  
BANKS FOR MARCH 1998**  
SOURCE: BI ANNUAL REPORT



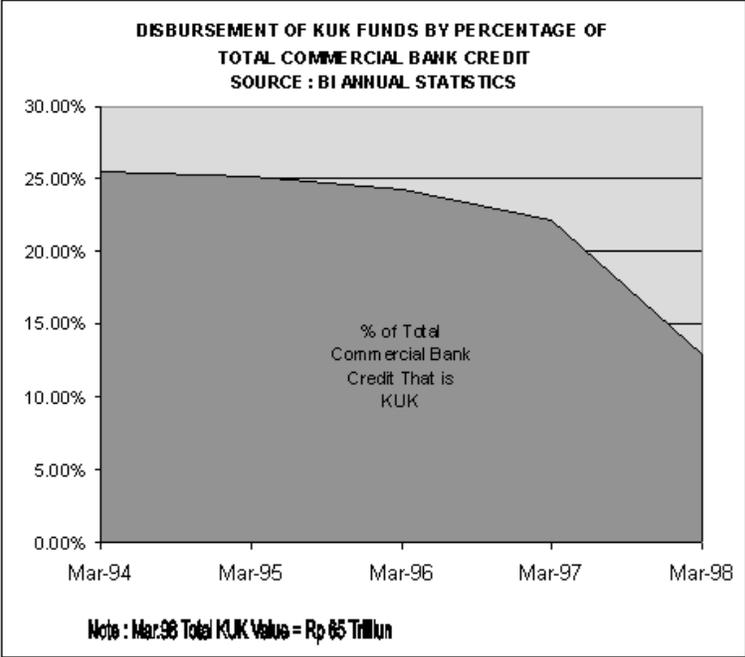
**Note : March 98 KUK Disbursed = Rp 65 trillion**

c. **Disbursement of KUK funds by percentage of total commercial banks credit**

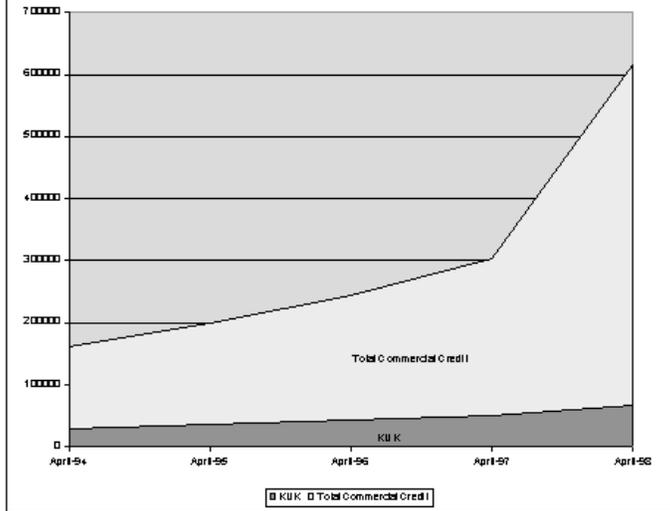
Total credit extended by all commercial banks in March 1998 was around Rp 550.5 trillion. Bank of Indonesia credited about Rp 65.8 trillion as loans classified as KUK credit. This value of KUK equals 13 % of total credit. According to the regulation, commercial banks would have been expected to release a minimum 25 % of total credit or Rp 137.6 trillion. Banks were complying with the KUK requirement in March 1994 and March 1995. Since September 1995 the percentage of KUK to total credit of commercial bank has been falling as shown in **Figure 10** and **Figure 11**. Since April of 1997 higher inflation further distorted the domestic credit picture and in real terms the value of KUK decreased. As Indonesia entered the crisis commercial banks dollar denominated loans have continued to rise as the Rupiah fell in value. In today's crisis commercial bank portfolio that one year ago reflected a 20% foreign denominated loans exposure and an 80% Rupiah exposure find the picture exactly reversed. For most banks little new lending is occurring and with the rule changes KUK requirements have declined.

**FIGURE 10**

**FIGURE 11**



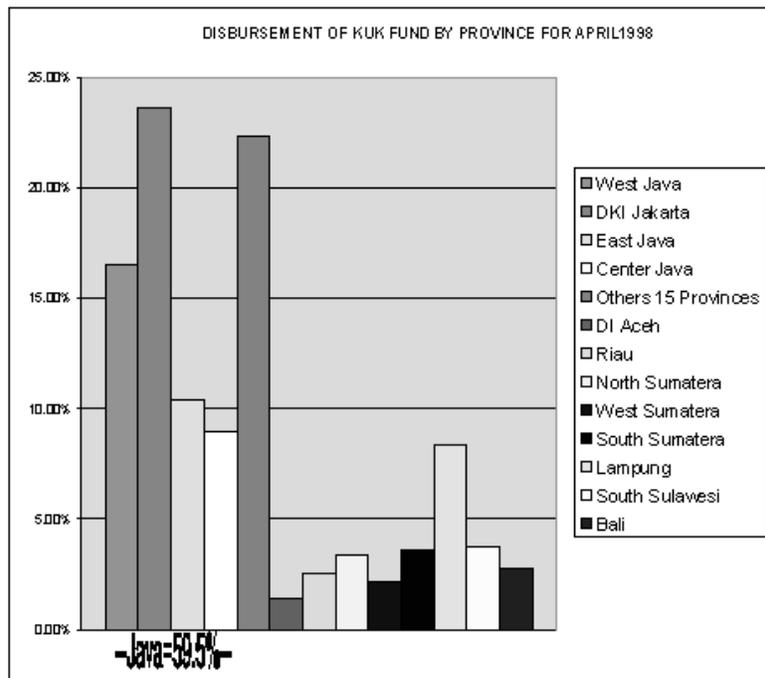
DISBURSEMENT OF COMMERCIAL BANK AND KUK FUNDS FROM APRIL 1984-APRIL 1992  
SOURCE: BIENNIAL STATISTICS



d. **Disbursement of KUK funds by Province**

Around 59.5 % of KUK disbursement is on the Island of Java (West Java 17.6 %; DKI Jakarta 16.7 %; East Java 15.3 %; Central Java 13.6 % and Yogyakarta 1.3 %). The rest are distributed outside Java (see **Figure 12**). Java's population represents 60% of Indonesia total population which is consistent with the KUK disbursement presented here..

**FIGURE 12**



**Trend Overview on KUK**

**Trend of KUK base on end use**

Trend of KUK base on end use shown that 48 % of KUK portfolio is for financing of working capital, 16.6 % of KUK is for financing of investment and 35.4 % KUK is so called as consumptive credit (which 17.4 % of KUK is for financing of low cost

housing.

### Trend of KUK base sector

In December 1993 Trade, Restaurant and Hotel sectors have the highest rates of absorbing KUK funds, or about 40.9 % of the KUK portfolio. There is a shift in industry mix in March 1998, the shift is from the Trade, Restaurant and Hotel sectors to Construction, Property, and other sectors. This equals 36.2 % of the KUK pie, as seen in **Table 5**.

**TABLE 5**

### **DISTRIBUTION OF KUK BY SECTOR**

| ECONOMY SECTORS                 | KUK VALUE<br>DEC' 93<br>Rp million | PERCENTAGE<br>DEC.'93 | KUK VALUE<br>MARCH'98<br>Rp million | PERCENTAGE<br>MARCH'98 |
|---------------------------------|------------------------------------|-----------------------|-------------------------------------|------------------------|
| AGRICULTURE                     | 1,825                              | 6.6 %                 | 6,077                               | 9.2 %                  |
| MANUFACTURING<br>INDUSTRY       | 2,802                              | 10.1 %                | 7,187                               | 10.9 %                 |
| TRADE,<br>RESTAURANT<br>& HOTEL | 11,362                             | 40.9 %                | 17,681                              | 26.8 %                 |

|           |       |        |        |        |
|-----------|-------|--------|--------|--------|
| SERVICES  | 5,310 | 19.1 % | 11,081 | 16.8 % |
| O T H E R | 6,479 | 23.3   | 23,863 | 36.2 % |
| SECTORS   |       |        |        |        |

Source : Bank Indonesia, Monthly Report Banks

Financing of working capital takes 48% of the KUK portfolio. Trade, restaurant and hotel as a sectors which have big part of working capital of KUK (Rp 15,276 million). For investment finance agriculture take a big portion of KUK (Rp 3,819 million) as illustrated in **Figure 13** and **14** below.

**FIGURE 13**

**FIGURE 14**

