MICROFINANCE SECTOR REVIEW AND PROGRAM ASSESSMENT INDONESIA

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I. EXECUTIVE SUMMARY

The Program for Eastern Indonesia Small and Medium Enterprise Assistance (PENSA) is funded by a multi-donor consortium led by the International Finance Corporation (IFC) and was founded in September 2003 with the task of improving lives and livelihoods by expanding the range of opportunities and capabilities for small and medium businesses. The IFC commissioned Banyan Global, a NY-based consulting firm with expertise in microfinance to conduct a sector study on microfinance as well as validate IFC PENSA's proposed interventions. In addition, the consultancy was to explore finance linkages for two sectors in which PENSA operates, handicrafts and agri-business, respectively in Sulawesi and Bali. These are covered in separate reports that are complementary to this sector study.

Banyan Global conducted a six-week field assessment in March and April of 2005 to collect primary and review secondary data sources on the microfinance sector in Indonesia. A total of 51 institutions were interviewed, some more than once, along with interviews of select IFC staff. Banyan Global utilized semi-structured interview guides and focused on qualitative data collection to address the requirements of the study.

Key Findings of the Microfinance Sector Study

- There are numerous types of organizations engaged in microfinance in Indonesia. These include commercial banks (BRI), rural banks, NGOs, and informal providers.

- Support structures for retail microfinance institutions abound in Indonesia. These offer a wide range of services such as wholesale financing, capacity-building, and lobbying and advocacy for the sector. Besides these entities there is a broad range of donors who are active in channeling funds for on-lending, providing operational support to MFIs, and providing technical assistance on regulatory issues.

- Despite a long history of microfinance activity in Indonesia, other than BRI, there has been little progress with regard to achieving scale and commercialization of the sector. The key gaps that have hindered this growth and commercialization include:

    1. There are few credible retail MFIs. Many continue to demand collateral and are disguised “loan sharks”.
    2. There is inadequate legal cover for all types of institutions operating in microfinance.
    3. There is insufficient protection for all micro-depositors. In particular, clients of cooperatives and credit unions do not have depositor's insurance.
    4. There are regulatory constraints for scaling up by BPRs.
    5. There are weak institutional capacities of retail institutions. They often have a narrow range of financial products and they lack innovation to address the under-served segments of the market.
    6. There are poor systems and organizational processes for retail institutions.
    7. There is weak capacity of support structures to support microfinance.

Validation of IFC's Proposed Strategy

IFC/PENSA has identified four key interventions to address constraints of the microfinance sector in Indonesia. These four areas are:

1. Development of large apex company.
2. Development of rating agency.
3. Strengthening capacity of current MFIs through an Indonesian microfinance learning center.
4. Expanding microfinance services in Eastern Indonesia with the development of a capital investment company to assist new MFIs develop in Eastern Indonesia.

Given that the objective of IFC PENSA is to increase commercialization and scale of the microfinance sector in Indonesia, the main role envisaged for IFC PENSA by the Assessment Team is that of a 'market developer' for microfinance, rather than a direct provider. This role entails supporting existing or new institutions to address market gaps or weaknesses, in a commercially viable way. The Banyan Global team believes that the four areas initially identified can be refined to serve the 'market developer' role which will eventually have more significant and broader impact for the microfinance sector in Indonsia.

- Apex Structure: The rationale for creating an apex institution is based on the limited supply of both financing and technical assistance in any given market. In the Indonesian case, the market exhibits an abundance of supply of financing and technical assistance. On the other hand, there is limited demand for commercial financing or technical assistance among existing retailers of microfinance. IFC should address weaknesses on the demand side by raising the capacity of retailers in order to absorb commercial financing.

- Rating Company: Findings of the sector study demonstrate that asymmetry is not the barrier to accessing commercial funds by BPRs. Rather, investors, deposits and lenders have all identified the creditworthiness of BPRs as the main reason for their inability to access funding. Many of the existing commercial sources of finance are not fully utilized. As such, creating a rating agency is unlikely to have an impact in improving access to commercial finance by BPRs. Rather, to address the credit worthiness of BPRs, the focus should first and foremost be on their capacity.

- Learning Center: There are an abundance of technical assistance providers in Indonesia. Despite this, the quality of retail institutions remains weak. Before creating a new entity, the IFC should first assess the exiting suppliers and determine ways in which improving quality of service delivery can be achieved.

- Investment Company: The findings of this assessment show that before additional financing is made available to BPRs, (whether equity or debt), it is essential for the main weaknesses of these institutions, namely capacity and governance, are addressed. Only after a sufficient number of BPRs are made investment worthy should investors consider making additional investments into BPRs. Thus, this objective is considered a second phase of IFC support and should not be the focus for immediate intervention in the sector.

IFC's main partners were envisioned to be cooperatives, credit unions and BPRs. This evaluation has found that cooperatives and credit unions are both plagued with a variety of weaknesses which will limit their potential to grow into commercially viable institutions with significant client outreach. BRPs, while still weak, present more viability as a partner for the IFC.

BPRs have both regulatory as well as capacity issues which need to be addressed to improve their long-term viability. Three regulatory features adversely affect BPRs' ability to be key financial intermediaries. These are: lack of access to the payments system and consequently their inability to offer check services or ATM withdrawals; restrictions on their ability to accept foreign currencies or even deposits from foreigners; restrictions on branching and geographic coverage which keep them fairly small. Institutionally, BPRs' business model as is currently applied is unsuited for becoming viable microfinance institutions. Generally, BPRs are small, have an unclear target market, limited coverage, poor governance structures, negative public image and poor portfolio quality or back office systems. They offer few market driven products and services. Their lack of performance is disguised with high interest rates to ensure their profitability. Should the IFC focus on BPRs as its main retail partner for microfinance, it must address the existing regulatory and institutional weaknesses of this retailer group.

Recommendations for Programming

Banyan Global has identified three distinct areas for support, some of which overlap and reinforce each other. These include support for capacity building, ensuring access to finance and promoting an enabling environment. The sequencing of the interventions is of particular importance as only the appropriate interventions at the appropriate stage of development of the sector will ensure that further commercialization takes place.

<u>Support for Capacity Building</u>
First and foremost, the Banyan Global team believes that the IFC should focus on addressing the investment worthiness of BPRs through enhancement of technical assistance and training opportunities. To properly address this major market weakness, the IFC will need to look at both sides of the equation, both demand for and supply of technical assistance. This will require much deeper analsyis of the technical assistance needs of BPRs. It will also require a deeper analysis of existing technical assistance providers. A summary of interventions include:

- Idenfity needs of BPRs through a mapping study and conduct needs assessment for different market segments of BPRs.
- Identify possible TA providers through institutional assessments.
- Develop market based approach to address weaknesses of TA providers and offer incentives for delivery of market based support to BPRs.

<u>Access to Finance for BPRs</u>
To achieve commericalization, BPRs or other microfinance institutions must raise capital from savings, borrow from commercial banks, or obtain investments from private investors. As a market facilitator, the IFC should focus on enhancing these vehicles for funds. In the Indonesian case, given that there are numerous commercial sources of finance, raising the creditworthiness of retailers is the key to enhancing financial flows. Identifying partners for support is daunting given that there are over 2,000 BPRs in Indonesia. The IFC should allow self-selection as one mechanism for sifting through the many BPRs in the market. Once there is a sufficient pool of creditwothy BPRs, the IFC should explore investing in or creating a local financing company which will take equity stakes in sound BPRs. The legal viability of this alternative will first need to be explored.

Promote an enabling Environment

The final area of IFC's support should include the longer-term systemic weaknesses in the market, the legal and regulatory issues which hinder sound governance and growth of many MFIs, including BPRs. Banyan Global recommends that the IFC should leverage its relationship with BI to improve the regulatory framework for BPRs to encourage better governance, build consumer confidence, reduce geographic limitations and promote efficiency.