[Washington International Law Journal](https://digitalcommons.law.uw.edu/wilj)

Volume 10 | Number 1

12-1-2000

Microfinance and Poverty Alleviation: Lessons from Indonesia's Village Banking System

Yoko Miyashita

MICROFINANCE AND POVERTY ALLEVIATION: LESSONS FROM INDONESIA'S VILLAGE BANKING SYSTEM

Yoko Miyashita

Abstract: Indonesia needs an aggressive poverty reduction strategy to counter the 1997 Asian financial crisis, which has propelled millions of its citizens into poverty. Microfinance is a proven method of reducing poverty and has been successfully used within Indonesia in government-supported programs. In addition to continuing its state-run microfinance programs, Indonesia should support increased non-governmental organization ("NGO") participation in microfinance programs by permitting NGOs to conduct the full range of activities of a state-run microfinance program. Such a move would help to ensure that microfinance services reach people with the least access to the formal financial sector.

I. INTRODUCTION

As Indonesia rebuilds an economy that was devastated by the 1997 Asian financial crisis, it will have to institute policies which are geared towards reducing the growing number of those living at or near poverty levels. In addition to the twenty-two million people living in poverty before the crisis, the number of people living below the poverty line increased by 50% when Indonesia was unable to stabilize the value of its plummeting currency.[1] Moreover, these numbers do not take into account the additional millions who are currently hovering just above the poverty line.[2] For Indonesia to improve living conditions for the entire populace, any plans to rebuild the economy must include "pro-poor" growth strategies.

Microfinance, the delivery of financial services to the poor, is a pro-poor, cost-efficient, poverty reduction strategy. The world's poor lack access to financial services, especially credit and savings facilities.[3] Microfinance institutions ("MFIs") have been created to address this shortage. Experiences over the last twenty years indicate that financial services can be delivered to the poor at market rates, and without ongoing

---

[1] Anne Booth, *The Impact of the Crisis on Poverty and Equity*, 15 ASEAN ECON.BULLETIN 353, 356 (1998); The World Bank, *The World Bank and Indonesia* (visited Oct. 6, 2000) <http://www.worldbank.org> [hereinafter The World Bank and Indonesia].

[2] The World Bank and Indonesia, *supra* note 1.

[3] JOANNA LEDGERWOOD, MICROFINANCE HANDBOOK: AN INSTITUTIONAL AND FINANCIAL PERSPECTIVE 1 (1999).

donor or government subsidies.[4] These services in turn generate income for low-income clients.[5]

Indonesia should combat the recent increase in poverty by extending microfinance services to areas where the poor still lack access to financial services. Indonesia has successfully developed state run MFIs that are financially viable and reach communities underserved by the commercial financial sector.[6] It has shown that a financial institution can deliver financial services to poorer communities, not only cost-effectively, but also profitably. Statistics have shown that Indonesia's successful microfinance programs have, in fact, helped reduce the level of poverty among program beneficiaries.[7] Looking at the successful microfinance programs, it is clear that these programs share a core set of operating principles and procedures. By forming new MFIs that operate under similar principles and practices, Indonesia can combat the recent increase in poverty by ensuring that most underserved, poorer populations have access to financial services.

In addition to increasing the number of state-run MFIs, Indonesia should encourage the development of NGO provided financial services. While its government-developed programs have managed to bring financial services to the traditionally underserved, the gradual increase in minimum loan amounts indicates that these services may not be reaching the most destitute.[8] Whereas a large state-run organization may have difficulty identifying and reaching the most marginalized populations, smaller NGOs would have the flexibility to target populations living in isolated communities. To promote the development of financially viable NGO MFIs, NGOs should incorporate the core principles and practices of Indonesia's successful state-run MFIs, to the extent such principles do not interfere with a NGO's need for flexibility in its operations. Bolstering NGO involvement in microfinance services will require Indonesia to permit NGOs to engage in all microfinance activities. Furthermore, Indonesia should take steps to provide a framework for informally regulating such NGO-run microfinance programs.

This Comment proposes that Indonesia should fight the growth of

---

4 *Id.* at 3-4.

5 *Id.* at 3.

6 *See infra* Part III.

7 *See infra* Part III.

8 R. Marisol Ravicz, The World Bank, *Searching for Sustainable Microfinance: A Review of Five Indonesian Initiatives* 9 (1996) (visited Oct. 6, 2000) <http://www.worldbank.org/html/dec/Publications/Workpapers/WPS1800series/wps1878/wps1878.pdf>. Whereas loan amounts for several microcredit organizations in Indonesia ranged from $11 to $440, the Indonesian government's largest microfinance organization (the Bank Rakyat Indonesia Unit Desa Program) had an average loan amount of $896. *Id.* (All dollar values are in U.S. currency, unless otherwise specified.)

poverty among its people by establishing more MFIs that operate based on the core set of principles and practices derived from its successful MFIs. Accordingly, Indonesia should promote the development of NGO MFIs by providing a regulatory framework which permits NGOs to deliver all financial services that the poor require, with the flexibility necessary to service isolated, poorer communities. Part II describes the development of microfinance as a poverty reduction strategy. Part III addresses the development of microfinance in Indonesia. Part IV discusses Indonesia's financial crisis and how microfinance can fit into a free market strategy for broad-based economic reform. Part V discusses the policy changes Indonesia can institute to help extend the reach of microfinance to more of its poor citizens.

II. THE DEVELOPMENT OF MICROFINANCE

In the past ten years, microfinance has gained recognition within the development field as an economic and social empowerment mechanism and effective tool to fight poverty. Microfinance refers to the provision of financial services to low-income clients, including the self-employed.[9] These services may include small loans, typically used for working capital (also referred to as "microcredit"), secure savings products, insurance products, and training programs for microentrepreneurs.[10]

Through the provision of credit, many poor people become self-employed and, in turn, create employment opportunities for others. Microcredit programs extend small loans to poor people for self-employment projects that generate income, allowing them to care for themselves and their families.[11] In addition to generating income for individual needs, microcredit loans help the self-employed expand their businesses and create jobs for others.[12] There is a growing body of evidence showing that access to credit helps poor people work their way out of poverty.[13] Microcredit clients throughout the world have reported real

[9] LEDGERWOOD, *supra* note 3, at 1

[10] *Id.* Microfinance is further characterized by collateral substitutes, streamlined loan disbursement and monitoring, and the access to repeat and larger loans, based on repayment performance. *Id.* This Comment will only address the microcredit and savings components of microfinance.

[11] The Microcredit Summit, *Declaration and Plan of Action, Feb. 2-4, 1997* (visited Oct. 6, 2000) <http://www.microcreditsummit.org/declaration.htm> [hereinafter Microcredit Summit Report].

[12] Shahidur R. Khandker, Fighting Poverty with Microcredit: Experience in Bangladesh 1-2 (1998).

[13] Microcredit Summit Report, *supra* note 11.

A. *The Unfulfilled Demand for Financial Services in Poorer Communities*

The lack of access to small amounts of capital is seen as a primary reason why many of the world's poor remain socially and economically immobile. The majority of people living in developing countries make a living through small-scale self-employment.[15] Also known as "microenterprises," these self-employment schemes are usually small, family-owned businesses that are unregulated and part of the "informal sector."[16] Approximately 500 million microentrepreneurs operate in the world today.[17] Despite their economic activity, many microentrepreneurs remain trapped in poverty. Lack of credit is cited as a primary reason for their inability to pull themselves out of poverty.[18] Prosperous economies depend on credit;[19] yet for many microentrepreneurs, credit is not readily available for working capital to pay for raw materials and inventory.[20]

The risks and high transaction costs associated with lending to the poor constitute a substantial barrier to formal financial institutions delivering these services. In any financial contract, the lender requires adequate and accurate information to assess the risk of lending to a borrower. To gain confidence in borrowers, financial institutions usually perform credit checks to ascertain each borrower's character, perform project appraisals to assess each borrower's business prospects, and take a security interest in collateral to secure loans.[21] These practices, however, cannot be used in lending to microenterprises.[22] Most microentrepreneurs do not have a credit rating, nor

---

interviews with 380 FINCA village bank borrowers in El Salvador revealed that weekly income increases averaged 145%. An Aspen Institute study of seven U.S. microfinance programs found that 62% of poor participants increased their household incomes over a three-year period. Of these participants, 68% increased their household income by more than 25%. Forty-two percent increased their incomes by more than 75%. *Id.*

[15] Muhammad Yunus, Poverty Alleviation: Is Economics Any Help? Lessons from the Grameen Bank Experience, 52 J. INT'L AFF. 47, 56 (Fall 1998).

[16] Id.

[17] LEDGERWOOD, *supra* note 3, at 1.

[18] Yunus, *supra* note 15, at 52.

[19] Charles Caldwell & Patrick Meagher, *Collateral Law and Economic Transitions*, 1 ECON. REFORM TODAY 301 (1996).

[20] Elisabeth Rhyne & María Otero, *Financial Services for Microenterprises: Principles & Institutions*, *in* THE NEW WORLD OF MICROENTERPRISE FINANCE 11-12 (María Otero & Elisabeth Rhyne eds., 1994).

[21] *Id.* at 13.

[22] *Id.*

do they maintain records necessary for performing project appraisals.[23] Furthermore, poorer clients lack marketable collateral.[24]

The transaction costs incurred in lending to poor clients also deter commercial banks from offering financial services to the poor. The concentration of commercial banks in urban areas increases the transaction costs of providing services to the poor, who often live in rural communities.[25] Furthermore, rural borrowers usually require individual small-sized loans, whereas commercial banks generally lend to large, established enterprises in modern industrial sectors.[26] The relative cost of extending such small loans to rural borrowers is much greater than the cost of lending to large-scale commercial borrowers.[27] Commercial lenders could offer services to the poor but they would have to increase their interest rates to reflect the fact that microfinance operations are more costly. However, rather than doing so, bankers often cite image or bad publicity problems associated with charging higher interest rates to poorer clients.[28]

The reluctance of formal financial institutions to extend credit to poor clients also applies to deposit services. The absence of financial institutions providing deposit facilities to poor clients is attributed to the mistaken assumption that poor people cannot save because they do not have the funds to save or because they choose to use their income for consumption needs.[29] The assumption fails to reflect the widespread practices of poor people saving cash, excess grain, and animals in the household.[30] People save for numerous purposes, including emergencies, investment, consumption, social obligations, education of children, pilgrimages, sickness, disability, and retirement.[31] Research on rural financial savings, informal savings mechanisms, in-kind savings as well as experience from savings banks,

---

[23] *Id.*

[24] *Id.*; *see also* JACOB YARON ET AL., THE WORLD BANK, RURAL FINANCE: ISSUES, DESIGN, AND BEST PRACTICES 18 (1997).

[25] YARON, *supra* note 24, at 18. Rural areas with low population densities are more difficult to service with a centrally-located bank branch office. *Id.*

[26] *Id.*; *see also* LEDGERWOOD, *supra* note 3, at 12.

[27] Because the cost of making a $100, $10,000, or $100,000 loan is virtually the same, poor people with smaller credit needs are not perceived as a profitable market for credit. *See* Microcredit Summit Report, *supra* note 11; *see also* YARON, *supra* note 24, at 18.

[28] Consultative Group to Assist the Poorest, *Commercial Banks in Microfinance: New Actors in the Microfinance World, Focus Notes No. 12* (July 1998) (visited Oct. 8, 2000) <http://www.cgap.org/html/p_focus_notes12.html>.

[29] Marguerite S. Robinson, *Savings Mobilization and Microenterprise Finance: The Indonesian Experience, in* THE NEW WORLD OF MICROENTERPRISE FINANCE, *supra* note 20, at 28.

[30] *Id.* at 32-33.

[31] *Id.*

cooperatives and deposit-taking MFIs has helped shatter this old perception that poor people cannot save.[32]

The dearth of formal deposit services in rural, poor communities can be explained by financial institutions' misunderstanding of clients' needs and clients' distrust of financial institutions. Operating on the mistaken assumption that poor people do not save, financial institutions argue that if poor populations do not save, there is no reason to develop institutions to serve them.[33] Traditional institutions are also reluctant to incur the relatively high transaction costs attendant to handling the small deposits of low-income clients.[34] Furthermore, low-income clients often lack the physical access to financial institutions, which usually have limited branch office networks.[35] In addition, poorer clients often distrust formal financial institutions.[36]

Despite the assumptions about poor clients and their inability to save, those in the development field have come to recognize that low-income households will deposit their surplus capital in financial institutions if the institutions are appropriately structured and offer the clients savings products that meet their specific needs.[37] An appropriately structured institution will take into account, among other things, the following factors:

- An institution accepting deposits from poor clients must be trustworthy;[38]

---

[32] Michael Fiebig et al., Consultative Group to Assist the Poorest, *Savings in the Context of Microfinance—State of Knowledge* 5 (1999) (visited Oct. 8, 2000) <http://www.cgap.org/assets/images/savings.pdf>.

[33] Robinson, *supra* note 29, at 28.

[34] LEDGERWOOD, *supra* note 3, at 156.

[35] *Id.*

[36] A 1987 Bank Indonesia Jakarta study found that rural undersavings was attributable to the "villagers' lack of trust in banks, their lack of education and consequent aversion to the use of financial institutions, and their 'psychological inability' to make use of banks." Bank Indonesia Jakarta dengan Pusat Penelitian Pembangunan Pedesaan dan Kawasan Universitas Gadjah Mada, 1987, *quoted in* Robinson, *supra* note 29, at 31; *see also* SUSAN JOHNSON & BEN ROGALY, MICROFINANCE AND POVERTY REDUCTION 20 (1997). When public confidence in financial institutions drops due to deteriorating political or economic conditions, clients, poor and non-poor, often choose not to deposit their savings in formal financial institutions. In Nigeria, when political difficulties resulted in a drop in public confidence in formal banks, customers chose to deposit their savings with non-bank deposit collectors rather than banks. The local people said they trusted the individual deposit collectors more than banks. JOHNSON & ROGALY, *supra*, at 20-21.

[37] Fiebig et al., *supra* note 32, at 1; *see also* Eric R. Nelson, Development Alternatives, Inc., *Financial Intermediation for the Poor Survey of the State of the Art, African Economic Policy Discussion Paper No. 10* (July 1999) (visited Oct. 8, 2000) <http://eagerproject.com/discussion10.shtml>.

[38] Because the deposit-taking institution is making a promise to (re)pay the depositor at a later date, trust is an important issue for poorer clients. Fraud or mismanagement of funds can lead to long-lasting distrust towards the institution. Fiebig et al., *supra* note 32, at 4.

- Poorer clients need a safe place to put their savings; a place that is secure not only from physical risks such as theft, fire, or flood but also from the demands of their families;[39]
- Women depositors need a place to put away small amounts in a safe place, where their families or husbands cannot gain access;[40]
- Poorer clients prefer to save in liquid instruments.[41]

An institution that can accommodate such needs of poorer depositors will find that poorer clients, in fact, do save and require the services of deposit-taking institutions.[42]

Commercial banks and financial institutions do not fulfill (or in the case of savings, do not recognize) poorer clients' needs for financial services. The relatively high costs and low profits involved with lending to poorer, rural clients deter commercial institutions from expanding the financial services market to include the poor. Exclusion from the commercial market does not mean, however, that the poor do not require these services. When commercial financial institutions fail to meet the needs of poorer clients, clients either go without financial services or seek alternative sources of borrowing and deposit-taking services.[43]

B. Current Informal Financial Services Fail to Meet the Needs of the Poor

Though informal financial services have developed to service populations excluded by the formal financial sector, these services are often inadequate and expensive. When poorer clients cannot obtain financial services from commercial institutions, they often turn to informal financial services for their borrowing or saving needs. Though informal financial systems are more available to microenterprises than formal systems, they do not offer the full range of services that formal institutions offer, and they often charge very high interest rates.[44] The inadequacy of informal financial services in fulfilling the needs of poor clients coupled with the inflated costs

---

[39] JOHNSON & ROGALY, *supra* note 36, at 22.

[40] *Id.* at 19.

[41] Fiebig et al., *supra* note 32, at 3-4. Liquidity, or unlimited ability to withdraw funds, is important because households often save for emergencies and investment opportunities, which can arise at any time. Robinson, *supra* note 29, at 35.

[42] Fiebig et al., *supra* note 32, at 3-4.

[43] *See infra* Part II.B.

[44] Rhyne & Otero, *supra* note 20, at 14.

of services makes them a less than ideal source of financial services for poor clients.

1. Informal Credit Services

Informal credit services come in many different forms.[45] Microentrepreneurs often seek credit from local moneylenders, who often charge exploitative interest rates.[46] In addition to moneylenders, the poor often turn to trade or dealer credit to fulfill their credit needs.[47] Less usurious sources of credit are also available through rotating savings and credit associations ("RoSCAs").[48]

In general, informal financial services providers have advantages over commercial financial institutions in delivering credit services to the poor. Informal moneylenders or members of a RoSCA have access to superior information about the borrower, lower overhead, and flexibility in delivering services. Often in informal lending settings, the lender has communal ties to the borrower as well as "insider knowledge" about the borrower.[49] Furthermore, the number of moneylenders in each community may be

---

[45] LEDGERWOOD, *supra* note 3, at 104.

[46] KHANDKER, *supra* note 12, at 2. For example, in Cochin, India, the *Tamilians* provide a money lending service to poor slum dwellers on a daily basis. They have set terms, which are well known all over Cochin. For each 100 rupees lent, three rupees are deducted as a fee at loan disbursement. Thereafter, the borrower must repay twelve and a half rupees per week for ten weeks. This works out at an annual percentage rate of 300%. JOHNSON & ROGALY, *supra* note 36, at 21. In Indonesia, informal moneylenders typically charge interest from 2 to over 35% per month, often on a flat rate basis. Marguerite Robinson, Harvard Institute for International Development, *Rural Financial Intermediation: Lessons from Indonesia Part One: The Bank Rakyat Indonesia: Rural Banking, 1970-71*, DEVELOPMENT DISCUSSION PAPER No. 434 at 73 (Oct. 1992). Such high interest rates inhibit poor households from investing in productive income-increasing activities. KHANDKER, *supra* note 12, at 2.

[47] Examples of trade credit can be found in many markets, where microentrepreneurs obtain fertilizer on credit from local shopkeepers, and at the close of market, return the money from sales and any balance of unsold stock to the shopkeeper. The microentrepreneur retains a small proportion of the money as earnings. JOHNSON & ROGALY, *supra* note 36, at 22. Dealer credit is common in agricultural areas, where farmers sell their crop in advance to earn cash during the "hungry" season, when their main crop is still in the ground. Called *ijon* in Indonesia, this type of arrangement results in the farmer selling his crop in advance usually to a grain buyer or his agent at a lower-than-market price. The lower-than-market price for the crop, when seen as a loan, translates into an interest rate from 10% to 40% a month. *Id.*

[48] In Rotating Savings and Credit Associations ("RoSCAs"), individuals form a self-selected group and agree to contribute a fixed amount of money at regular intervals. Each member then receives the lump sum on a rotating basis. JOHNSON & ROGALY *supra* note 36, at 17. Though members do not pay interest directly, those who benefit from the loan early are privileged over the members who do not receive the loan until the end of the rotation. The advantages of RoSCAs are limited by the inflexibility inherent in the lending scheme; members are not always able to receive loans when they need them or in the amount required. Furthermore, RoSCAs have the implied risk of some members dropping out before everyone has had a chance to receive the money pool. LEDGERWOOD, *supra* note 3, at 70.

[49] JOHNSON & ROGALY, *supra* note 36, at 16. Moneylenders can also closely monitor their clients to ensure repayment. KHANDKER, *supra* note 12, at 30.

limited, in which case disciplined repayment is the only means for borrowers to ensure that funds will be available for future loans.[50] In the case of RoSCAs, the flow of information within a community acts as a powerful incentive for members to pay their installments, as failure to pay may invite social ostracism from neighbors, friends or relatives.[51]

Informal moneylenders can also operate without incurring the transaction costs that make it unprofitable for commercial lenders to serve the poor. Moneylenders often live in the same community as the borrower, eliminating the costs of having clients located far from an office branch.[52] Unlike the formal financial sector, collateral is usually not required for loans; most are made based on a lender's familiarity with the borrower.[53] Thus, there is also little paperwork involved in applying for a loan.[54]

2. *Informal Savings Services*

As with informal credit sources, poorer clients can obtain informal savings services, but they are expensive and limited in their scope of available services. Informal savings services, including RoSCAs offer a safe place to store one's money, but there is often no interest payable on the amounts saved.[55] In some situations, poorer clients must pay to deposit their savings.[56] Unless appropriately structured financial services are made available to poor clients, the poor will continue to face formidable barriers to accessing credit essential for operating a successful enterprise and to accessing a secure, interest-bearing repository for their savings.

C. *The Development of Appropriately Structured Financial Institutions for the Poor*

As the need for suitable credit and saving services for low-income clients has become apparent, MFIs have emerged to serve populations excluded by formal financial services. MFIs can be NGOs, savings and loan

---

[50] JOHNSON & ROGALY, *supra* note 36, at 24.

[51] *Id.*

[52] Fiebig et al., *supra* note 32, at 6.

[53] LEDGERWOOD, *supra* note 3, at 70.

[54] *Id.*

[55] Robinson, *supra* note 29, at 29.

[56] In Nigeria, a peripatetic deposit-taker called the *alajo* goes door-to-door to collect deposits from customers in outlying regions. Deposits are collected from each client every two days. The *alajo* collects about ten to fifteen naira (about $0.50 to $0.75) at each visit, and charges the client one day's savings per month. Translated into a percentage rate, clients pay 6.6% a month or 80% of one month's deposits each year to deposit their money with an *alajo*. JOHNSON & ROGALY, *supra* note 36, at 21.

cooperatives, credit unions, non-bank financial institutions, or even government or commercial banks.[57] Currently, over 900 MFIs serve an estimated clientele of twenty million throughout the world.[58] Many MFIs are locally based, bringing services directly to the community. Their development as quasi-financial institutions has enabled them to deliver financial services without the rigidity of uniform service delivery prevalent among formal financial institutions.[59] Many MFIs, in fact, have integrated techniques of informal financial systems, such as use of "insider knowledge" and peer group lending, into their financial services programs.[60]

1. The Structure of Microfinance Programs

a. Identifying a target market

In delivering financial services, MFIs identify their target market in order to achieve the goal of reaching unserved or underserved markets.[61] By identifying clients based on characteristics such as their poverty level, ethnicity, caste, religion, gender, geographic location, or type of business activity, MFIs can pinpoint a target market they wish to service, and design a credit delivery model appropriate for that target.[62] To ensure that they serve their target market, MFIs institute policies limiting their services to clients with certain characteristics. For example, MFIs seeking to serve "ultra-poor" clients as opposed to "poor" clients may limit their services to clients who have a maximum level of income or assets.[63]

Many MFIs target women clients. Women represent the largest

---

[57] LEDGERWOOD, *supra* note 3, at 2.

[58] The Microcredit Summit, *Empowering Women with Microcredit: 2000 Microcredit Campaign Summit Campaign Report* (visited Oct. 8, 2000) <http://www.microcreditsummit.org/campaigns/report00.html>.

[59] JOHNSON & ROGALY, *supra* note 36, at 25.

[60] *Id.*

[61] LEDGERWOOD, *supra* note 3, at 34. "Targeting" involves identifying a group of potential clients who share certain characteristics, behave in similar ways, and are attracted to a specific combination of products and services. *Id.* at 33.

[62] *Id.* If a microfinance institution ("MFI") fails to articulate a target market, it can encounter difficulties in managing its operations and can have difficulty staying focused. An organization that provides financial services to the poor without defining who the poor are can end up operating with different credit delivery models, trying to serve different groups and satisfy different donors. *Id.*

[63] JOHNSON & ROGALY, *supra* note 36, at 36-37. Targeting may be implicit in the design of a loan product. For example, if the target market is poorer clients, small loan amounts and additional requirements like attending weekly meetings would make the loans less attractive to richer people. *Id.* at 37.

proportion of the poorest segments of the world's population.[64] They earn only 10% of the world's income and own less than 10% of the world's property.[65] In addition to the institutional biases against lending to the poor, impoverished women also face gender discrimination in accessing financial services.[66] Commercial banks may be unwilling to lend to women or accept deposits from them based on their perception that women do not have control over household income.[67] Cultural barriers that restrict women to the home may also make it difficult for women to access financial services.[68] By gearing their financial services towards women, many MFIs seek to empower women by increasing their economic position in society.[69]

b. Microcredit delivery techniques designed for poor clients

Much of the public attention on MFIs focuses on their microcredit lending services and the innovative lending policies attendant in delivering those services. While each institution has differing lending policies, microcredit lenders generally extend small, short-term loans to the poor who lack physical collateral.[70] Instead of using conventional collateral to secure loans, MFIs use collateral substitutes, such as character references, group-based joint liability schemes, and compulsory savings requirements.[71]

Character-based references can serve as an effective substitute for physical collateral in microcredit lending schemes. Where character-based references are used in the place of collateral, loan officers, often recruited locally,[72] visit various establishments in the community and ask about the potential client's character and behavior.[73] In addition to using character

---

[64] Fiebig et al., *supra* note 32, at 5. Of the 1.3 billion absolute poor living in the world today, 900 million are women. Microcredit Summit Report, *supra* note 11.

[65] Microcredit Summit Report, *supra* note 11.

[66] *Id.*

[67] LEDGERWOOD, *supra* note 3, at 38.

[68] *Id.* at 37.

[69] *Id.*; *see also* JOHNSON & ROGALY, *supra* note 36, at 38. "Microfinance interventions may lead to empowerment for women by increasing their incomes and their control over that income, . . .and increasing their participation in household decision-making. As a result, social attitudes and perceptions may change, and women's status in the household and community may be enhanced."

[70] Fawzi Hamad Al-Sultan, *Microfinance for Macro-results*, U.N. CHRON., Mar. 22, 1997, *available in* LEXIS, World News Database.

[71] *Id.*; *see also* JOHNSON & ROGALY, *supra* note 36, at 7.

[72] JOHNSON & ROGALY, *supra* note 36, at 7.

[73] LEDGERWOOD, *supra* note 3, at 137. In Indonesia's Badan Kredit Kecamatan ("BKK") program, character references from village heads are used to establish an individual's loan eligibility. Jeffrey M. Riedinger, *Innovation in Rural Finance: Indonesia's Badan Kredit Kecamatan Program*, 22 WORLD DEV. 301, 304 (1994). The BKK program's high repayment rates have been attributed to borrowers' reluctance

references as collateral, some MFIs use a borrower's character as leverage to induce repayment. MFIs may threaten to announce, through public signs or notices in the local newspapers, that a borrower has defaulted on a loan.[74] The risk of being embarrassed in front of family, peers, and neighbors often induces borrowers to repay their loans.[75]

Group-based lending schemes also act as security for repayment in many microcredit programs. In group-based joint liability schemes, if an individual member defaults on a loan, the group is ultimately responsible for repaying the full amount of the loan.[76] Individuals self-form into small groups and receive one loan for the entire group. Members then decide which individual will receive the loan. When the loan is repaid, the group receives another loan and it distributes the funds to another member. Joint liability of the group creates an environment of peer pressure that helps achieve credit discipline without physical collateral.[77]

Some microcredit programs require security for their loans through compulsory savings requirements. Where compulsory savings are used in lieu of collateral, MFIs require borrowers to set aside a certain amount in savings during the term of the loan. Part of the disbursed credit is withheld and transferred to a deposit account in the MFI.[78] Setting aside the funds restricts borrowers from using those funds in their business activities.[79] The borrower is usually restricted from withdrawing the savings during the term of the loan.[80] The compulsory savings are made available when the loan has been repaid.[81] The savings, then, can produce additional cash flow for borrowers at the end of the loan term.[82] In addition to serving as collateral, compulsory savings help clients to build assets.[83] Furthermore, compulsory

---

to default and thereby damage their reputation with village leaders and other villagers. Riedinger, *supra*, at 306.

[74] LEDGERWOOD, *supra* note 3, at 137.

[75] *Id.*

[76] JOHNSON & ROGALY, *supra* note 36, at 7.

[77] The Grameen Bank, in Bangladesh, is a pioneer in the field of group-based liability lending. In the Grameen scheme, five men or five women from the same community organize themselves into a group. Loans are made to two members at a time and the other members in the group do not begin receiving their loans until the first two members begin repayment. Yunus, *supra* note 15, at 55. In addition to a mandatory weekly group meeting, groups attend a weekly center meeting where all banking transactions are conducted openly in the presence of Bank members. JOHNSON & ROGALY, *supra* note 36, at 7. Open transactions at center meetings promote transparency, diminishing the risk of embezzlement and corruption. KHANDKER, *supra* note 12, at 29.

[78] Fiebig et al., *supra* note 32, at 14.

[79] LEDGERWOOD, *supra* note 3, at 138.

[80] *Id.*

[81] *Id.*

[82] *Id.*

[83] *Id.*

savings funds can serve as a capital base for an MFI's other lending activities.[84]

c. *Interest rates in microcredit*

Based on past experiences with subsidized credit, microcredit lenders have learned that subsidized interest rates are not an effective means of delivering credit to poor clients. Subsidized interest rate credit programs have consistently been abused by rent-seekers and have not reached the target group of the poor.[85] For example, development finance institutions such as agricultural development banks have attempted to deliver cheap credit to small farmers who do not have access to mainstream sources of credit.[86] The cheap credit, however, has often been captured by well-to-do farmers who have used their influence to obtain the cheaper credit to the exclusion of poorer farmers in need.[87]

MFIs have also learned that they must charge interest rates at or above market rates to be cost-efficient and to create sustainable microfinance programs.[88] Because the cost of delivering program services is high,[89] an MFI may often charge higher-than-market interest rates on their loan products to effect full cost recovery.[90] In Indonesia, several microfinance programs charge annual real interest rates of 50% or more.[91] Despite the high interest rates, the demand for loans remains high and clients diligently repay their loans.[92] This indicates that within a certain range, microfinance

---

84 Fiebig et al., *supra* note 32, at 15. The Bank Rakyat Indonesia ("BRI"), a state-run MFI in Indonesia, uses a variation of compulsory savings in its lending model, by requiring borrowers to pay additional interest each month. If the loan payments are made in full, and on-time each month, the additional interest is returned to the borrower at the end of the loan term. LEDGERWOOD, *supra* note 3, at 138.

85 Nelson, *supra* note 37.

86 JOHNSON & ROGALY, *supra* note 36, at 5.

87 YARON ET AL., *supra* note 24, at 3, 26. Diverted loans often went unpaid. In addition, during election time, public funds were used to waive overdue and outstanding loans. Widespread default and loan forgiveness resulted in the perception that subsidized credit was simply a government disbursement. This ultimately led to a rapid depletion of loan funds. JOHNSON & ROGALY, *supra* note 36, at 5, 51. *See also* YARON ET AL., *supra* note 24, at 3.

88 YARON ET AL., *supra* note 24, at 26. The sustainability of microfinance programs is dependent on the ability to break even given the cost of making a loan. To break even, the cost of making a loan (cost of funds plus administrative and default costs) must be less than or equal to the price (interest rate) of the loan. KHANDKER, *supra* note 12, at 84.

89 KHANDKER, *supra* note 12, at 29. The activities critical to maintaining high loan recovery rates, for example, group formation and training, are expensive.

90 LEDGERWOOD, *supra* note 3, at 18.

91 Ravicz, *supra* note 8, at vii. These rates, however, are considerably lower than the rates charged by moneylenders. *See supra* Part II.B.1.

92 *Id.*

clients are not interest rate sensitive.[93] Clients value continued and reliable access to credit and savings rather than lower interest rates.[94] Higher interest rates help to make a microfinance program self-sufficient, and greatly reduce a program's dependence on government or donor subsidies.[95]

d. Financial sustainability of microfinance programs

In addition to the direct benefit that low-income clients derive from microfinance services, microfinance programs are an attractive development intervention because of their potential to become financially self-sustaining.[96] Unlike direct interventions like food or grain subsidies that require a constant influx of funds, a microfinance program can become financially self-sustaining by mobilizing enough savings and assessing enough interest on loans to cover the costs of delivering services.[97] A financially self-sustaining MFI does not have to rely on government or donor funds, which are not always available, to continue operating.[98] Furthermore, long-term viability of the institutions is critical to maintaining client trust and high loan repayment rates.[99] Experience has shown, however, that total financial self-sustainability is difficult to achieve for many MFIs.

Even the Grameen Bank,[100] one of the few organizations that has almost achieved internal financial sustainability,[101] has had difficulty becoming subsidy free.[102] In order to be a fully sustainable microfinance

---

[93] LEDGERWOOD, *supra* note 3, at 15.

[94] *Id.*

[95] Dependence on government or donor subsidy without internal financial sustainability jeopardizes an MFI's sustainability because government or donor funds are not always available. Riedinger, *supra* note 73, at 303.

[96] LEDGERWOOD, *supra* note 3, at 3.

[97] KHANDKER, *supra* note 12, at 84.

[98] Borrower perception of a credit program's permanency is important for the program's continued success. Riedinger, *supra* note 73, at 307. Several programs use the availability of future loans as an incentive to induce timely loan repayment. *See infra* Part III. If a program's long-term viability is in question, clients lack the incentive of repaying on time in order to secure future loans.

[99] *See supra* note 38 and accompanying text.

[100] The Grameen Bank is a pioneer in the field of group-based liability lending. LEDGERWOOD, *supra* note 3, at 2. Started by Muhammad Yunus in Bangladesh in 1976, by 1991 915 branches of the Bank were serving 1.1 million clients. Robinson, *supra* note 46, at 59.

[101] The Bank first reported a profit in 1993. A microfinance program earns a profit when its average on-lending rate is higher than the break-even interest rate. The break-even interest rate is the rate at which the cost of operation (administrative, borrowing and default cost) equals interest income per dollar from lending. KHANDKER, *supra* note 12, at 97-98.

[102] Grameen's profit figures do not reveal the subsidies that support operations at the head office level. From its inception, the Grameen Bank has received donor resources, such as grants or concessional funds. Though it increasingly has turned to market sources for its funds, as of 1994, it still received

program, it would have to operate with zero reliance on economic subsidies.[103] Despite the difficulty of becoming self-sustaining, several microfinance programs have attained self-sustainability over time.[104] The successful programs include two government-sponsored microfinance initiatives in Indonesia, the Badan Kredit Kecamatan ("BKK") and Bank Rakyat Indonesia ("BRI").[105] These programs have aggressively mobilized large amounts of savings from the public and have lent at rates high enough to cover their costs of lending. These programs highlight the attractiveness of self-sustaining microfinance interventions.

2. *Assessing the Impact of Microfinance Programs*

Microfinance's ability to help microentrepreneurs generate income makes it an attractive intervention mechanism.[106] Research data support the anecdotal evidence that microfinance can lead to poverty alleviation.[107] In a 1996 World Bank study[108] of the socioeconomic effects of the Grameen

---

foreign and central bank loans and foreign grants. These loans were granted at a concessional rate, several points below the market interest rate. No interest, furthermore, is charged on grants. The Bank also received income subsidies, or donations, as well as an equity subsidy, which is the income from equity held by program members, government, and commercial banks, subject only to market interest rates. KHANDKER, *supra* note 12, at 102-03.

[103] *Id.* at 103. Khandker, however, projects that by raising its on-lending rate from 16.6% to 22.3%, the Grameen Bank could become fully self-sufficient. Irrespective of whether self-sufficiency is the desired end, Khandker points out that in 1994, the average cost of reaching a poor household in rural Bangladesh with the financial services of a microfinance program was about Tk440 ($11) a year. He bases this figure on the total subsidy provided to Grameen in 1994 divided by the number of borrowers during that year. Given the Grameen Bank's success in pulling families out of poverty, he posits that an $11 per person subsidy may be a small cost for the poverty alleviation results achieved. *Id.* at 103-04.

[104] *Id.* at 108.

[105] For a discussion of the BKK and BRI programs, *see infra* Part III.

[106] LEDGERWOOD, *supra* note 3, at 3.

[107] Success stories from microfinance participants best illustrate the potential benefits of microfinance services. Microcredit Summit Report, *supra* note 11. Nurjahan, a Grameen Bank client, never earned more than $37.50 in a year before joining the Bank. Five years after joining the Bank, her annual income had risen to $250; she also owned two goats, one pregnant cow, ten hens, and two-thirds of an acre of land worth $1000. She employed two farm hands to assist with her rice crop. Furthermore, she was able to keep her son in school. In a country where most children never reach the fifth grade, Nurjahan's son was in the eighth grade. *Id.* Romeo and his wife operated an upholstery workshop on the dirt shoulder of the road to Iloilo airport on the Philippine island of Panay. They had no money for supplies and had to ask for credit from their buyers to fill orders. They barely made enough money to feed their family. The course of business changed when they received a loan of P6,000 ($225) from a local Christian development organization. They used the cash for supplies and more workers; business grew quickly. Romeo and his wife have since borrowed and repaid three subsequent loans. They have sent heir two eldest children to college and are currently building a new home. Chris Prystay, *Small Loans and Hard Work Spark Entrepreneurial Spirit*, ASIAN BUS., Dec. 1996, *available in* LEXIS Worldnews Database.

[108] The study was conducted by Shahidur Khandker. For a discussion of the results, see KHANDKER, *supra* note 12.

Bank's activities, results indicated that microfinance services led to increased per capita expenditures, increased borrower net worth, increased schooling for children, and positive nutritional gains for children.[109] Studies of the BRI report similar successes. BRI borrowers enjoyed 25% growth in real profits, 21% growth in household income and 18% growth in employment per enterprise.[110]

3. *The Growing Popularity of Microfinance as a Poverty Alleviation Mechanism*

The growing number of well-documented success stories, like the Grameen Bank and BRI, has led to a widespread adoption of microfinance as a viable poverty reduction intervention.[111] In a time when rich countries have cut foreign development assistance, microfinance is seen as a cost-effective way of fighting poverty.[112] Microfinance's popularity is best evidenced by the Microcredit Summit that was convened in Washington, D.C. in 1997.[113] Attendees of the Summit committed to expand the reach of microfinance to 100 million of the world's poorest families by the year 2005.[114] The estimated cost of reaching this goal is close to $22 billion.[115]

The United Nations ("UN") and the world's major development agencies also support microfinance as an effective poverty reduction strategy. In 1997, the UN passed a declaration highlighting the effectiveness of microcredit in poverty reduction.[116] The resolution calls upon UN

---

[109] *Id.* at 46-49. "Poverty reduction estimates based on consumption impacts of credit indicate that 5% of program participants can lift their families out of poverty each year by participating in and borrowing from microfinance programs." *Id.* at 148.

[110] Stephanie Charitonenko et al., *Sustainable Banking with the Poor, Case Studies in Microfinance: Indonesia: Bank Rakyat Indonesia Unit Desa 1970-1996* (June 1998) (visited Oct. 8, 2000) <http://www-esd.worldbank.org/html/esd/agr/sbp/98abst./brifin.htm>.

[111] LEDGERWOOD, *supra* note 3, at 4.

[112] *Microlending: From Sandals to Suits*, ECONOMIST, Feb. 1, 1997, at 75. The Organization for Co-operation and Development ("OECD") reported that official development assistance from OECD members to developing countries and multilateral development agencies fell from 1992 to 1997. Aid fell from 0.33% of their combined GNP to 0.22%. Aid did increase in 1998 to 0.23% of their combined GNP, but much of this is attributed to the surge in loans going to countries affected by the Asian financial crisis. *Financial Flows to Developing Countries in 1998: Rise in Aid; Sharp Fall in Private Flows*, OECD NEWS RELEASE (June 10, 1999) <http://www.oecd.org/media/release/nw99-60a.htm>.

[113] Paige Bowers, *The First Lady Endorses Microcredit Efforts: Small Loans Found to Have Big Results*, WASH. TIMES, Feb. 4, 1997, *available in* 1997 WL 3662828.

[114] Microcredit Summit Report, *supra* note 11.

[115] *Id.*

[116] G.A. Res. 52/194, U.N. GAOR, 52nd Sess., Agenda Item 97(f), U.N. Doc. A/RES/52/194 (1998). The resolution noted that microcredit has: succeeded in generating productive self-employment; increased the participation of poor people in the mainstream economic and political process of society; empowered women; and contributed to the social and human development process. *Id.*

organizations to explore including the microcredit approach in their programs as a tool to eradicate poverty.[117] In line with the UN's resolution, international development organizations, including the World Bank and the Asian Development Bank, now highlight microfinance as a key component in their poverty eradication strategies.[118]

III. MICROFINANCE IN INDONESIA

East Asian and Pacific Rim countries have been particularly successful in effectuating microfinance as a poverty reduction strategy. An inventory of twenty-eight MFIs in East Asia and the Pacific Rim, conducted by the Sustainable Banking with the Poor Group ("SBP"),[119] indicates that as of 1996, over 66% of outstanding microcredit loans in the world were serviced by MFIs in the region.[120] The MFIs have also been successful in mobilizing savings.[121] Their success in mobilizing local savings has reduced their dependence on subsidies from donors, as compared to MFIs in other regions.[122]

The numbers in SBP's inventory of East Asian and Pacific Rim MFIs reflect the activities of the BRI, one of the largest microfinance institutions in the world. According to the inventory, the BRI's Unit Desa ("BRI-UD"), or village unit, program has mobilized $2.51 billion of total savings deposits in the region, and together with four other commercial banks, holds 99% of the value of microcredit loans in the East Asian portfolio.[123] The BRI-UD is one of several state-developed initiatives designed to address the problem of limited access to credit for small-scale entrepreneurs in Indonesia. In addition to the BRI-UD, several other government-sponsored microfinance

---

[117] *Id.* at ¶ 6.

[118] World Bank, *Financial Sector: Rural & Microfinance/SMEs* (visited Oct. 6, 2000) <http://www1.worldbank.org/finance/html/micro_finance.html>; *see also* Asian Development Bank, *Fighting Poverty in Asia and the Pacific: The Poverty Reduction Strategy of the Asian Development Bank* 1 (1999) (visited Oct. 8, 2000) <http://www.adb.org/Documents/Guidelines/Poverty_Reduction/Poverty_Policy.pdf>.

[119] "SBP is a collaborative effort of the World Bank, Royal Ministry of Foreign Affairs of Norway, Swiss Agency for Development and Cooperation, and the Ford Foundation." *Sustainable Banking With the Poor—A World Bank Project* (visited Oct. 6, 2000) <http://www-esd.worldbank.org/sbp>. Its stated purpose is to help "improve the ability of donors, governments, and practitioners to build sustainable financial institutions that effectively reach the poor." *Id.*

[120] Sustainable Banking With the Poor, *An Inventory of Microfinance Institutions in East Asia and the Pacific*, at IV (visited Oct. 6, 2000) <http://www-esd.worldbank.org/sbp>. MFIs in the region had 9.3 million outstanding loans with a loan portfolio value of $4.1 billion. The average loan size was $440 or 53% of the GNP per capita. *Id.*

[121] *Id.* at V. Some of the MFIs have compulsory savings requirements. *Id.*

[122] *Id.* at VII.

[123] *Id.* at IV-V.

programs, such as the BKK in the Central Java and South Kalimantan Provinces, and Badan Kredit Desa ("BKD") in individual villages, help to create a country with a rich microfinance environment. Many of these programs operate locally,[124] building on Indonesia's long history of village level financial institutions.[125] Since 1898, Indonesia has had village level financial institutions that have provided small loans to microenterprises. These institutions have served as working examples for many of the Indonesian microfinance programs in operation today.[126]

A. The BRI-UD Program

Established in 1970 as part of the state-owned BRI,[127] the BRI-UD program is one of few programs that has mobilized enough savings and lent at high enough interest rates to become a financially viable microfinance intermediary.[128] The Unit Desa ("UD") program was formed originally to administer the Bimbingan Massal ("BIMAS"), or mass guidance, agricultural credit program.[129] Under the program, 3600 new bank branches were established on Java, Bali and the outer islands.[130] The bank's role was to channel credit directly to participating farmers.[131] The BIMAS program

---

[124] Ravicz, *supra* note 8, at vii-viii.

[125] Charitonenko et al., *supra* note 110. Many of Indonesia's microfinance programs are locally based. To understand the structure and outreach of these programs, it is helpful to have a general understanding of the political subdivisions below the central government:

CENTRAL GOVERNMENT
PROPINSI (PROVINCE)
KABUPATEN/KOTAMADYA (DISTRICT)
KECAMATAN (SUB-DISTRICT)
DESA (VILLAGE)

Adapted from Charitonenko et al., *supra* note 110.

[126] *Id.*

[127] *Id.*

[128] KHANDKER, *supra* note 12, at 15. *See also* Paul B. McGuire et al., *Getting the Framework Right: Policy and Regulation for Microfinance in Asia*, § 2.1 (1998) (visited Oct. 6, 2000) <www.bwtp.org/publications/pub/Appendix3.htm>. The BRI has 300 branch offices in provincial and district centers and operates 3,600 village banking units. At the end of 1996, 2.5 million loans were outstanding from Unit Desa ("UD"), with a total value of $1.7 billion. These banking units also held close to sixteen million savings accounts totaling $2.6 billion. *See* McGuire, *supra*, § 2.1.

[129] Charitonenko et al., *supra* note 110.

[130] James Boomgard & Kenneth Angell, *Bank Rakyat Indonesia's Unit Desa System: Achievements and Replicability*, *in* THE NEW WORLD OF MICROENTERPRISE FINANCE, *supra* note 20, at 207. Most of the banks were located in kecamatan (subdistrict) capital towns and served an average of eighteen villages. *Id.* *See also* Robinson, *supra* note 46, at 21.

[131] Boomgard & Angell, *supra* note 130, at 21.

peaked in the mid-1970s, declining rapidly thereafter as wealthier farmers captured the cheap credit, and in turn, defaulted on the loans.[132]

In 1984, the BRI-UD program faced growing losses; the UD were no longer receiving subsidies for the BIMAS program and the government's budget was diminishing rapidly.[133] Dismantling the UD would have eliminated banking in approximately 90% of the country.[134] It would have also displaced the 14,000 trained UD employees.[135] Rather than dismantling the infrastructure developed in creating the UD, the Indonesian government sought to transform the UD into financially viable microfinance intermediaries. The goal was to discontinue subsidies to the UD within two years.[136] Offering one loan product, Kredit Umum Pedesaan[137] ("KUPEDES"), and one national savings instrument called TABANAS,[138] the UD program achieved financial sustainability within the two-year subsidy cushion. Without the unexpected costs that arise from creating a new organization, the UD were able to assess their operating costs and accurately price the KUPEDES product and the TABANAS accounts.[139] Within two years of the BIMAS program's termination, the UD had been transformed into profitable microfinance intermediaries.[140]

The UD operate as a profit center within the larger BRI.[141] The BRI-UD are subject to "clear and transparent" reporting requirements and are

---

[132] *Id.* at 207-08; *see also* Riedinger, *supra* note 73, at 303. There were no penalties for delinquent payments and the program often forgave past-due loans. Riedinger, *supra* note 73, at 303. In addition, a series of rice crop failures from the mid-1970's to mid-1980's had a major negative effect on the results of the agricultural credit program. Robinson, *supra* note 46, at 23.

[133] Dropping international oil prices eroded Indonesia's oil revenues, which financed more than 60% of the government's budget. Boomgard & Angell, *supra* note 130, at 208-09.

[134] Robinson, *supra* note 46, at 16.

[135] Boomgard & Angell, *supra* note 130, at 209.

[136] Charitonenko et al., *supra* note 110.

[137] Kredit Umum Pedesaan ("KUPEDES") loans were extended to men and women for any productive enterprise. *Id.*

[138] TABANAS is a nationally sponsored savings program by the Bank of Indonesia that has been in operation since 1976. *Id.* It pays 1.25 % monthly interest and restricts withdrawals to two per month. *Id.*

[139] The program assumed that its loan funds would come from savings deposits in the TABANAS accounts, carrying a cost of funds of 15%. *Id.* Accounting for inflation, the nominal interest for a KUPEDES loan was set at 32%. The spread in interest between KUPEDES and TABANAS was sufficient to cover all operating costs. *Id.*

[140] *Id.*

[141] LEDGERWOOD, *supra* note 3, at 16. Each UD has a minimum staff of four consisting of a general manager, a loan officer, a bookkeeper, and a cashier. When the number of staff grows to eleven, a UD is split into two separate units. UDs may establish service posts, manned by a bookkeeper and a cashier, to service the needs of clients in outlying areas. The service posts collect savings and loan payments and loan applications, but do not make loans. Boomgard & Angell, *supra* note 130, at 210.

accountable to a larger BRI branch office.[142] Funds available to the UD program are provided from several sources, including grants and savings mobilization. Grants are the only direct subsidies that UD receive, and they are limited to a BRI grant disbursed when a UD is formed.[143] The most important source of funds for the UD is mobilized savings. The UD program has been self-funding since 1989, when the total amount in deposits surpassed total amounts loaned.[144] The UD place their excess savings in BRI branch offices where they earn an 18.6% transfer fee.[145]

UD's lending activities are conducted through KUPEDES loans. Loans are available at interest rates considerably lower than those charged by informal moneylenders for all "income-generating activities."[146] Loans require collateral, though household removables may be enough to satisfy the requirement.[147] The loan application process takes approximately one week for a new customer; the loan turnaround is shorter for repeat borrowers.[148] Loan officers maintain close contact with their clients, visiting them as often as once or twice each week.[149] Through these visits, loan officers screen clients based on the information they gather about a client.[150]

Through interest rebates, access to future loans, and staff incentives, the BRI-UD maintain a strict repayment culture among its clientele.[151] At the end of 1996, there was close to $1.7 billion of credit outstanding to

[142] McGuire et al., *supra* note 128, § 2.1. Each branch office of the BRI (located in kecamatan capital towns) has a UD business manager who visits each UD regularly to monitor its operations, cash balances, and financial controls. Boomgard & Angel, *supra* note 130, at 210.

[143] Boomgard & Angell, *supra* note 130, at 211. Newly established UD receive an initial equity contribution of about $9000. *Id.*

[144] *Id.* at 212.

[145] *Id.* The branch offices use UD deposits as a source of liquidity for other lending activities. *Id.*

[146] Charitonenko et al., *supra* note 110; Robinson, *supra* note 46, at 40.

[147] McGuire et al., *supra* note 128, § 2.1; *see also* Robinson, *supra* note 46, at 31; *but see* Charitonenko et al., *supra* note 110 ("[UD] were legally required to take collateral but were flexible in doing so. . . Collateral is strongly desired but not mandatory.")

[148] Charitonenko et al., *supra* note 110.

[149] *Id.*

[150] *Id.*

[151] The interest rate on KUPEDES loans is at or near 32%. Generally, the loans mature over one year and payments are made on a monthly basis. *Id.* When loan payments have been made in full and on time each month, up to twelve percent of the interest payments may be returned to a borrower at the end of the loan period. This is referred to as the "Prompt Payment Incentive." LEDGERWOOD, *supra* note 3, at 138. Clients perceive the incentive as a positive incentive rather than a potential penalty. Robinson, *supra* note 46, at 32. The availability of larger loans in the future is also used as an incentive to induce timely repayment. Staff bonuses are linked to the performance of the loan portfolio, and thus, they create incentives for staff to screen and monitor clients more carefully. Ultimately, if the client does not repay, penalties may be assessed, though foreclosure is unlikely because the small size of the loans and the costliness of foreclosure procedures make foreclosure cost-prohibitive. Charitonenko et al., *supra* note 110.

approximately 2.5 million borrowers.[152] The long-term loss ratio for the islands of Java and Bali averaged 2.2%, while the ratio on other islands ranged from 1.9% to 4.8%.[153] The UD profits before tax in 1996 were $177 million.[154] The UD's financial success has been so significant that UD profits have been used to subsidize the BRI's other clients.[155]

The minimum loan size in 1996 was $10.50, but few loans below $50 have been made since 1987.[156] As of January 1995, only 14.6% of the KUPEDES credits consisted of loans below $215.[157] The maximum loan size has grown from $1000, in 1984, to $10,500, in 1996.[158] The average loan size in 1996 was $1007, though 70% of the loans were below that average.[159]

In addition to a successful microcredit program, the UD have mobilized savings, that have been vital to the program's financial success. Prior to the transformation of the UD into microfinance intermediaries in 1984, each UD had mobilized about $8,000 in savings.[160] By December 1996, the average savings per UD had risen to $800,000.[161] The average savings balance per client was $163, or 16% of the average annual income for Indonesians.[162] As of December 31, 1996, the total amount of UD deposits was $3 billion.

The UD's remarkable success in mobilizing savings can be attributed to the BRI's extensive research and implementation of products suitable for varying client needs. In addition to the TABANAS savings product, which had been offered since 1976, the BRI introduced three new products to serve the various savings needs of clients.[163] While TABANAS offered 15% annual interest on savings, it limited withdrawals to two per month. Savers did not like the limited liquidity of the product. In response to market surveys, the BRI introduced a new unlimited withdrawals savings product,

---

152 Charitonenko et al., *supra* note 110.

153 The long-term loss ratio is the total amount overdue one day or more at the end of the period (Dec. 1996), including amounts written off, divided by the total amount which has fallen due between Feb. 1984 and Dec. 1996. *Id.*

154 *Id.*

155 LEDGERWOOD, *supra* note 3, at 143. In essence, poorer clients of the BRI-UD program have subsidized BRI's wealthier clients at lower interest rates. *Id.* These wealthier clients, in turn, defaulted on their loans when the Asian Financial Crisis hit, prompting a massive effort to recapitalize BRI. *See infra* Part V.B.6.

156 Charitonenko et al:, *supra* note 110.

157 McGuire et al., *supra* note 128, § 2.1.

158 Charitonenko et al., *supra* note 110

159 *Id.*

160 *Id.*

161 *Id.*

162 McGuire et al., *supra* note 128, § 2.1.

163 Robinson, *supra* note 29, at 41, 43.

SIMPEDES.[164] SIMPEDES paid less interest than TABANAS,[165] but its liquidity made the product attractive.[166] To augment the SIMPEDES product, the BRI instituted the SIMASKOT product, an urban version of SIMPEDES for use in unit banks established in cities.[167] In addition to TABANAS, SIMPEDES, and SIMASKOT, the BRI introduced the Deposito Berjangka ("DEPOSITO") in 1986 for timed deposits.[168]

The success of the UD program has translated into real benefits for the poorer population in Indonesia. Credit needs that were never sufficiently addressed through subsidized credit programs have been served through a well-managed KUPEDES product. Because the UD programs offer credit at higher-than-market interest rates, poorer borrowers do not have to worry about wealthier clients capturing credit to their exclusion.[169] Savings products now exist that suit the individual needs and preferences of poorer clients. BRI studies indicate that very few borrowers who have borrowed from UD three or more times remain below the poverty line.[170] UD borrowers enjoyed 25% growth in real profits, 21% growth in household income, and 18% growth in employment per enterprise.[171]

B. *Locally-Based Microfinance Programs*[172]

The smaller, government sponsored microfinance programs help fill gaps in the BRI-UD's service network. The programs discussed below are sponsored by the provincial or village governments. In comparison to the BRI-UD program, these programs have a smaller loan portfolio, smaller loan

---

[164] *Id.* at 41.

[165] At the end of 1996, SIMPEDES paid 0% monthly compounded interest on average monthly balances below Rp25,000 (about $11), 0.75% on balances from Rp25,000 to Rp200,000 (about $11 – $85), and 1.125% on amounts above Rp200,000. Charitonenko et al., *supra* note 110.

[166] *See* Robinson, *supra* note 29, at 43. Furthermore, the BRI instituted a non-cash prize bi-annual lottery at the district level for SIMPEDES clients. Charitonenko et al., *supra* note 110.

[167] Robinson, *supra* note 29, at 43. SIMASKOT carries a separate interest rate schedule than SIMPEDES and its lottery prize is in cash, but the product is essentially the same as SIMPEDES. Charitonenko et al., *supra* note 110.

[168] The deposits have maturity periods of one, three, six, twelve or twenty-four months. The interest paid on Deposito Berjangka ("DEPOSITO") is higher than the other products (18-21%), and the product appeals to clients who often save for particular future goals, such as retirement, pilgrimage, or building construction. Robinson, *supra* note 29, at 43-44.

[169] See *supra* Part II.C.1.c for a discussion regarding wealthier clients who capture cheap credit to the exclusion of poorer clients.

[170] Charitonenko et al., *supra* note 110.

[171] *Id.*

[172] The MFIs presented in this section do not present a complete inventory or description of all locally-based MFIs. Information about the MFIs discussed in this section is based on Riedinger, *supra* note 73, and Ravicz, *supra* note 8.

amounts, higher interest rates, and not as many depositors. Their operating costs are considerably higher than the UD, since many of the organizations do not have the structural backing of a large institution like the BRI. Furthermore, costs are higher since many of these MFIs attempt to reach clients located in the outermost regions of the country.

1. Central Java's BKK Program

The BKK Program in Central Java, in operation since 1972, provides credit and savings services to the population of Java.[173] In 1972, the governor of Central Java instituted the BKK program to provide fast, cheap, and productive credit to the rural poor.[174] In response to the failure of the BIMAS program to reach the poor, the BKK was instituted with different policies, including elimination of subsidized credit and extension of credit for non-agricultural purposes.[175] By shifting away from cheap credit, reducing administrative costs through simplified procedures, charging interest rates high enough to cover costs[176] and prevent capital erosion, and maintaining high repayment rates, the BKK has developed into a financially viable MFI.[177]

The use of character references has been a particularly effective method of securing loans and facilitating high repayment. Because many Central Javanese villages are close-knit and hierarchical, borrowers are reluctant to default on their loans and risk damaging their reputations with village leaders and other villagers.[178] Of the cumulative amount lent before December 1989, only 2.1% has not been repaid.[179] In addition to relying on character to maintain high repayment rates, the BKK also uses the

---

[173] *See generally* Riedinger, *supra* note 73, at 306.

[174] *Id.* at 303.

[175] *Id.* at 303-04.

[176] Borrowers paid monthly interest rates ranging from 5.3% to 6.9% depending on the repayment term. The rates were high enough to deter wealthier clients who would have otherwise sought cheap credit. Loans also have a mandatory savings component requiring borrowers to deposit 6.5% to 20% of the loan amount in a savings account. *Id.* at 304. Despite the fact that the BKK charged higher than market interest rates and required mandatory savings deposits, the program has grown every year since its inception. The success of the program, despite high interest rates and savings requirements, supports findings that microentrepreneur borrowers are less concerned with formal interest rates than with credit availability and convenience. *Id.* at 305.

[177] *Id.* at 309.

[178] *Id.* at 306.

[179] *Id.* As of 1992, the BKK had made about 500,000 loans totaling close to Rp49 billion (about $24 million). *Id.* at 305, tbl.I. The average loan size was Rp121,000 ($58.50). *Id.* at 305-06. A majority of BKK's borrowers (55%) are women and more than half have not completed primary education. *Id.* at 306.

availability of future loans for higher amounts as an incentive for timely repayment.[180]

Local BKK branches have the flexibility of operating as a local grass-roots organization, while maintaining the benefits of oversight by a large financial institution. Though each BKK branch is financially autonomous, each branch is supervised by the Bank Pembangunan Daerah ("BPD") or Provincial Development Bank.[181] With support from the government, the BKK program has been able to become a financially viable MFI by instituting simplified procedures, charging high enough interest rates, obtaining prudent supervision, and creating a strong repayment culture.[182] The BKK has brought valuable financial services to the poor in Central Java.[183]

2. *South Kalimantan's BKK Program*

The South Kalimantan provincial government has owned and operated a BKK program ("SK-BKK") since 1985. It is modeled on Central Java's BKK program but functions independently of it.[184] Like the BKK in Central Java, the SK-BKK has successfully used character references to extend a large number of loans and maintain a healthy repayment rate.[185] The SK-

---

[180] *Id.* Additionally, the BKK offers staff performance incentives (in the form of bonuses) to expand the clientele, retain existing clientele, and to maintain high repayment rates. *Id.* at 304.

[181] *Id.* at 302. Within the scope of administrative guidelines issued by the Bank Pembangunan Daerah ("BPD"), BKK branches have the freedom to operate as the needs of its clientele dictate. The BPD supervises the individual units and also provides technical assistance (particularly in designing and implementing a set of simple, standardized, operating procedures). *Id.*

[182] KHANDKER, *supra* note 12, at 15 n.3.

[183] A survey of the BKK program conducted in 1982 by the U.S. Agency for International Development indicated that borrowers, through an average loan of Rp59,000 ($88 in 1982), increased the amount of time they devoted to their microenterprises and generated 0.3 new full-time jobs and 0.4 new part-time jobs. This data indicates that for every $220 loaned out, one new full-time job is created. Riedinger, *supra* note 73, at 306. The average annual salary of a full-time laborer in rural Java in 1982 was roughly equal to $220. This means that for a $220 loan, one full-time job could be created at a cost no greater than the salary associated with the job. *Id.* If a $220 loan can create one job, the cost is low enough such that there exists great potential for high replicability. In addition to employment gains, 90% of borrowers surveyed reported cost-savings, which they used to expand their businesses, improve their housing, or to increase their personal consumption. *Id.*

[184] Ravicz, *supra* note 8, at 32.

[185] In addition to character references, South Kalimantan BKK ("SK-BKK") requires that a borrower have a business or employment to be considered for a loan. Furthermore, if the loan is for more than Rp200,000 ($86), the borrower must provide a vehicle or land as collateral and the head of the subdistrict must approve the loan. If a borrower is married, his or her spouse will be required to sign the promissory note. *Id.* at 33, 35. In 1995, SK-BKK units made 34,518 loans totaling Rp7.8 billion ($3.4 million). Loans ranged from $21 to $428 in size. *Id.* at 33, 38. Borrowers generally paid 2.5% interest per month and made mandatory savings deposits with each loan. Of the loans made in 1995, the SK-BKK's arrears rate was 5.9% of outstanding loans and the default rate was 3.5%. "Arrears rate" is the amount of overdue

BKK maintains high repayment rates by using the availability of future loans as a repayment incentive and by sending loan officers to visit a borrower's village if the payment is overdue by several days.[186] Organizationally, the SK-BKK functions similarly to the BKK in Central Java.[187] Like the BKK in Central Java, the SK-BKK branches have the benefit of prudential supervision by a large banking institution, yet have the leeway to tailor their services to client needs.

Though the interest rate[188] of SK-BKK loans may be higher than loans offered through BRI-UD, SK-BKK better targets a poorer clientele. SK-BKK has lower average loan amounts and lower maximum loan amounts than BRI-UD. The majority of borrowers are petty traders [189] who generally have smaller loan requirements.[190] Though BRI-UD's loans are available at a cheaper rate, poorer clients seeking smaller loans may have to bear higher interest rates to cover the costs of outreach for service in outlying regions and the lack of a large institutional infrastructure.

3. *The BKD Program*

BKD is a system of village-owned and operated non-bank financial institutions operating in East, West, and Central Java and Yogyakarta Provinces.[191] BKD units issue credit and also accept voluntary savings. Its loan funds come from an initial capital grant from the provincial governments, earnings from activities, and mandatory and voluntary savings.[192] Though BKD units do not require an ongoing subsidy, some of

---

loan principal (or principal plus interest) divided by the loan portfolio outstanding. LEDGERWOOD, *supra* note 3, at 265. Loans that are overdue by ninety days or more are considered to be in default. Ravicz, *supra* note 8, at 35.

[186] Ravicz, *supra* note 8, at 35.

[187] The 110 SK-BKK branches are supervised by the BPD. Though the BPD is supposed to make official policy decision regarding branch activities, i.e., the types of savings and loan products to be offered, individual branch managers often end up making these decisions. *Id.* at 32-33.

[188] Though the program's interest rates are high enough to cover the cost of operations, SK-BKK receives many in-kind subsidies, such as free building space, furniture, motorcycles, staff training, guidance, and supervision. Thus, it is difficult to determine the financial sustainability of the program. *Id.* at 32.

[189] *Id.* at 39.

[190] The varying terms of SK-BKK loans (ten weeks to eighteen months) as opposed to the twelve-month term of a Bank Rakyat Indonesia Unit Desa ("BRI-UD") loan, also indicate that SK-BKK may be a purer MFI, strictly adhering to the microfinance philosophy of short-term, small-amount loans.

[191] *Id.* at 76. Badan Kredit Desa ("BKD") were established by Dutch Ordinance in 1898, and have existed in their present form since 1952. As of 1996, there were 4,806 active BKD in Indonesia. *Id.*

[192] *Id.* Some BKD units may borrow funds from other BKD, the local government, or the BRI. *Id.*

the units have slowly decapitalized; in 1992, the BRI recapitalized 1,000 units.[193]

The BKD's lending experience also provides support for the effectiveness of character references as a collateral substitute. Like the BKK programs in Central Java and South Kalimantan, the BKD programs rely on character references to establish a borrower's creditworthiness.[194] Part-time staff members hired from within the village run the day-to-day operations out of the village leader's home or a public building.[195] In 1996, the BKD made 1.8 million loans totaling close to $131 million while maintaining a low default rate of 5%.[196] BKD clients paid interest rates higher than rates charged by the BRI-UD or the BKK programs; interest rates equaled 7.2% per month.[197] Even with the higher-than-market interest rates, the BKD attracted a large number of borrowers, supporting the proposition that access to loans and convenience are more important to borrowers than interest rates.[198] Like the BKK programs, the BKD are able to operate as independent units while maintaining the benefits of oversight by a larger, formal financial institution.[199]

C. *NGO Involvement in Microfinance Activities*

While the Indonesian government has broadly supported microfinance activities administered by the BRI and BPDs, it has not provided equal support for NGO involvement in microfinance.[200] One reason for this is Indonesia's wide-reaching Department of Home Affairs, which administers health, family planning, family welfare, and agricultural agencies throughout

---

[193] *Id.* at 80.

[194] *See* Riedinger, *supra* note 73; Ravicz, *supra* note 8, at 35.

[195] Ravicz, *supra* note 8, at 76, 80. Staff members are hired from within the village. *Id.* at 77. Inferring from the structure of BKD units (operations out of the houses of village leaders; administration by fellow village members), social pressure must operate to induce borrower repayment. *Id.*

[196] *Id.* at 19, 77. The average loan amount was $71 (or 7% of the GDP per capita), with loans ranging from a minimum of $11 to a maximum of $257. *Id.*

[197] *Id.* at 77. BKD loans have a mandatory savings component, whereby, for a loan with a twelve-week term payable in equal weekly installments, the first payment represents the interest on the loan, the second payment represents a forced savings payment, and the remaining payments account for the loan principle. *Id.*

[198] *See* discussion *supra* Part II.C.1.c.

[199] *See* discussion *supra* Parts III.B.1. and III.B.2. Each BKD unit is supervised by a BRI staff member, who visits the unit at least once a month to review the unit's bookkeeping, cash handling, and loan portfolio quality. Ravicz, *supra* note 8, at 76-77. This structure permits local village members, with their superior information, to make decisions about loan allocation, yet ensures that the financial operations of the unit are sound.

[200] McGuire et al., *supra* note 128, § 1.4.

the provinces.[201] The various agencies often subsume microfinance into their offered services.[202] Furthermore, government officials are reluctant to support NGO activities (in microfinance and social services) because of the fear that such support will shift political energy and influence away from the state's own agencies.[203]

The government's failure to help develop NGO microfinance initiatives can also be explained by its steadfast support for the village cooperative (Koperasi Unit Desa or "KUD") system. Since 1967, the government has promoted KUDs as a vehicle for government social programs, including microfinance programs.[204] Administered by the Department of Cooperatives, there are currently 34,000 officially-supported KUDs.[205] The KUDs have been beneficiaries of a large amount of government resources; the Central Bank's data indicates that as much as 12.3% of all credit it extended as of March 1994 went to KUDs for lending.[206]

One Indonesian NGO providing microfinance services is Bina Swadaya.[207] Bina Swadaya is a multi-faceted NGO that provides a range of services, including microfinance services.[208] With a staff of 700, this NGO delivers direct financial services through the five rural banks it owns.[209] Bina Swadaya is also a participant in a larger government initiative, Program

---

[201] *Id.*

[202] *Id.* For example, the family planning board offers a subsidized, group-based lending program for poor families. Ravicz, *supra* note 8, at 23.

[203] McGuire et al., *supra* note 128, § 1.4.

[204] *Id.* § 1.3. The Koperasi Unit Desa ("KUD") play an important part in the Indonesian national ideology of *Pancasila*. *Id.* *Pancasila* encompasses the five founding principles of the Republic of Indonesia: Belief in the One Supreme God; just and civilized humanity; democracy led by the deliberations among representatives; and social justice for the whole people of Indonesia. The Virtual Library on Microcredit, *Bina Swadaya*, (visited Oct. 6, 2000) < http://www.soc.titech.ac.jp/icm>.

[205] McGuire et al., *supra* note 128, § 1.3.

[206] The suitability of KUDs as MFIs is questionable. The KUD are reputed to be "largely inefficient, corrupt, and smothered by central government bureaucracy" and known for their poor financial practices (including failure to adhere to prudent banking standards). *Id.*; *see also* Ravicz, *supra* note 8, at 27.

[207] McGuire et al., *supra* note 128, § 1.4. Bina Swadaya is short for Badan Pengembangan Swadaya Masyarakat or Community Self-Reliance Development Agency. The Virtual Library on Microcredit, *supra* note 204.

[208] Bina Swadaya's activities include: education and training; promotion of women in development; microfinance development; micro enterprise development, social forestry development; sustainable agriculture development; integrated irrigation development; health and environment development; agribusiness development; magazine publication; book publication; printing house; alternative tourism; policy dialogue; and poverty alleviation. The Virtual Library on Microcredit, *supra* note 204.

[209] McGuire et al., *supra* note 128, § 1.4. Under the 1992 Banking Act, banks were divided into two types: Bank Perkreditan Rakyat (people's credit banks, frequently referred to as rural banks) and commercial banks. Rural banks are small-scale savings banks that accept time and savings deposits and extend credit. They are limited in terms of location, function and portfolio composition and, furthermore, do not offer check or foreign exchange facilities or participate in the payment systems. *Id.* § 4.1.

Hubungan Bank dan KSM ("PHBK"), a microfinance program sponsored by the Bank of Indonesia and the German government's Agency for Technical Cooperation.[210] The PHBK program pairs banks (mainly rural banks and BPDs) with NGOs that loan funds to credit groups, which then disburse funds to group members.[211] The NGOs are free to establish the terms under which they will make loans.[212] While free to establish loan terms as their needs see fit, the PHBK encourages NGOs to require a 20% mandatory savings deposit in lieu of collateral.[213] NGOs operating under the program offered loans with monthly interest rates ranging from 3.2% to 15.3%.[214] The PHBK program does not reliably track annual defaults, thus, accurate data is not available on PHBK loan performance.[215]

Current regulations governing NGO activities hamper their ability to become financially self-sustaining organizations. Current laws permit NGOs to pursue almost any economic activity, so long as those activities further social objectives.[216] Thus, NGOs can conduct microcredit lending activities.[217] However, NGOs are prohibited from mobilizing savings from its members.[218] This limitation on savings mobilization eliminates a key source of funding for NGO MFI activities.[219]

A 1992 banking law also affects the ability of NGOs to become effective MFIs. In 1992, the government passed a regulation requiring small financial institutions that accept deposits to convert into rural banks or cooperatives.[220] Becoming a rural bank has been difficult for many

[210] Ravicz, *supra* note 8, at vii.

[211] *Id.* at 52.

[212] *Id.* at 9.

[213] *Id* at 10.

[214] Most loans do not exceed $400-$500, with most loans averaging about $110, or 13% of the GDP per capita. *Id.* at 10, 19.

[215] *Id.* at 14. The program managers of Program Hubungan Bank dan KSM ("PHBK") estimate that the cumulative default rate since the program's inception is 2-3% . *Id.*

[216] McGuire et al., *supra* note 128, § 3.1.

[217] *Id.*

[218] *Id.*

[219] For a discussion of the importance of savings mobilization as a source of funding, see *supra* Part II.C.1.d.

[220] Ravicz, *supra* note 8, at 4. The Law states, "Any parties conducting business such as collecting funds from the public in the form of deposits comprising demand deposits, time deposits, certificates of deposit, savings, and/or other equivalent forms of deposits, shall be required to obtain an operating license as a Commercial Bank or a Rural Bank from the Minister, except the concerned business of mobilizing funds from the public as stipulated in a separate Act." Act of the Republic of Indonesia, No. 7 of 1992, art. 16(1) [hereinafter Law No. 7/1992], *reprinted in* BINHADI, FINANCIAL SECTOR DEREGULATION BANKING DEVELOPMENT AND MONETARY POLICY 425 (1995). The Act further provided that non-bank financial institutions had one year from the date of the Act to transform themselves into a licensed rural or commercial bank. *Id.* art. 57.

institutions because of the high minimum capital requirement of $25,000.[221] Furthermore, becoming a cooperative is not preferred because cooperatives are governed by the KUD,[222] which has a poor record of managing financial institutions.[223] The practical effect of this regulation has been that those financial institutions unable to meet the capital requirement of becoming rural banks, including NGO MFIs, have been forced to develop in sub-optimal ways.[224] Inability to accept deposits, in turn, has prevented MFIs from becoming financially viable.

IV. MORE MICROFINANCE FOR INDONESIA

With the onset of the 1997 Financial Crisis, poverty levels in Indonesia have skyrocketed, and the need for microfinance services has become more acute. The banking system is in ruins; many of Indonesia's state and commercial banks are in a state of insolvency.[225] The banks' insolvency has meant that credit is not readily available for all of Indonesia, rich and poor alike.[226] As a significant part of the population has been pushed into poverty, Indonesia will have to institute poverty reduction mechanisms to bring the country back to economic health. In addition to the various subsidies for food and health needed to address immediate concerns, Indonesia needs broad-based reforms to achieve high quality growth. Microfinance, with its proven success in fighting poverty,[227] should be a part of the country's broad-based economic reforms. Unless the government aggressively allocates additional funds for microfinance programs, poor clients will be left without financial services and without the means to work their way out of poverty.

---

[221] Law No. 7/1992, *supra* note 220.

[222] KUD is the organization charged with organizing cooperative activities in Indonesia. The KUD is run by BAPPENAS, the national development coordination authority. RAVICZ, *supra* note 8, at 4.

[223] *Id.* For a discussion of the shortcomings of the KUD system, see *infra* Part IV.B.6.

[224] *Id.* For example, the SK-BKK has discontinued mobilizing deposits to comply with this regulation. The Law provided that the SK-BKK, as well as the BKD and SK-BKK were to become licensed rural banks only upon meeting each of the requirements stipulated in the Act. Law No.7/1992, art. 58. Parties who accept deposits without a license to operate as a rural bank may be subject to imprisonment for up to 15 years and a maximum fine of up to $5 million. Law No.7/1992, art. 46(1).

[225] After prolonged discussions with the IMF, the Indonesian government determined that it would have to recapitalize, restructure, or shut down fifty-nine banks, which held 66% of all assets in the banking sector. Charles Enoch, *Int'l Monetary Fund, Interventions in Banks During Banking Crises: The Experiences of Indonesia* 4 (IMF Pol'y Discussion Paper No. PDP/00/2, Mar. 2000) *available in* IMF website (visited Oct. 6, 2000) <http://www.imf.org/external/pubs/ft/pdp/2000/pdp02.pdf>.

[226] Dan Murphy, *Corporate Treasury: Indonesia: Play Now, Pay Later*, FAR E. ECON. REV., FOCUS 40 (May 27, 1999), *available in* 1999 WL-FEER 8675092.

[227] *See* discussion *supra* Part III.B.4.

Indonesia should turn to its government-sponsored system of successful, self-sustaining microfinance programs to address the financial service needs of the poor (and newly poor). The BRI-UD, BKK, and BKD programs all provide models for additional government-sponsored MFIs. These new state-run MFIs should be located in areas with high poverty levels and limited access to financial institutions. They should institute similar operating principles that have been developed by the village-level MFIs. To fulfill its obligations to the IMF under the proposed economic bailout, the government should channel a portion of the $47 billion aid package to new state-sponsored MFIs.[228] In addition to an increased number of state-run MFIs, the government should direct funds to the development of NGO MFIs. Like the state-run MFIs, NGO MFIs should also adhere to the core principles established by the programs mentioned above. By expanding the number of MFIs serving the poor, Indonesia will facilitate pro-poor growth strategies that will help stabilize the economy.

A. Indonesia's Financial Crisis

The 1997 Asian Financial Crisis[229] shattered much of the economic success that Indonesia had experienced over the past thirty years. Since Soeharto came to power in 1996, the country saw real annual growth of approximately 7%, and average annual inflation under 10%.[230] Its currency exchange rate stayed relatively stable against the dollar, and the economy grew to be ASEAN's[231] largest in terms of total (although not per capita) GDP. Following the crisis, however, the economy shrank by 14% in 1998, while inflation ran at about 70%.[232] The annual per capita income measured in dollars on a nominal exchange rate fell from $1200 to $400, jettisoning many into poverty and unemployment.[233] Of the 220 million people in Indonesia, several estimates project that the percentage of people living

---

[228] *See* discussion *infra* Part IV.A.

[229] Zakaria Haji Ahmad & Baladas Ghoshal, *The Political Future of ASEAN After the Asian Crisis*, 75 WORLD AFF. 759, 764-65 (1999). The crisis began in July 1997, when currency traders attacked the Thai currency, followed by the Malaysian, Philippine, South Korean, and Indonesian currencies. The over-supply of short-term foreign credit and the countries' insistence on keeping exchange rates tied to the U.S. dollar led to a wide variation between the actual value of the currencies and their pegged rates. When the governments were forced to release their currencies, the plunge in value was dramatic. *Id.*

[230] Gerry Van Klinken, *From Go-Go to Yo-Yo*, 54 INSIDE INDONESIA (Apr.-June 1998) (visited Oct. 8, 2000) <http://www.insideindonesia.org>.

[231] The Association of South East Asian Nations ("ASEAN") includes Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam. Association of Southeast Asian Nations Home Page (visited Oct. 6, 2000) <http://www.aseansec.org>.

[232] Ahmad & Ghoshal, *supra* note 229, at 766.

[233] *Id.*

below the poverty line has jumped from 11.3% in 1996 to as high as 48% as of 1998.[234] This means that the number of people living in poverty increased from 22.5 million to about 100 million.[235] Unemployment also has risen to around eighteen million.[236] In light of such numbers, any economic plan to rebuild Indonesia's economy will have to include an aggressive poverty alleviation strategy.

The IMF is administering a $43 billion economic rescue package to draw Indonesia out of financial ruin.[237] A portion of the funds will go towards developing social safety net programs, and the Indonesian government has pledged to earmark some of these funds for microcredit programs to assist small businesses.[238] Since 83% of agricultural households received no formal credit and 93% of the capital of households with business activities came from their own funds and "other sources" in 1991,[239] it is likely that small businesses in existence today are in dire need of access to credit.

MFIs are likely to be in high demand, as more people have joined the informal sector as a result of the Financial Crisis.[240] Demand for microfinance services will be ever increasing, especially since the failure of Indonesia's state and commercial banks has put an increasing strain on available credit. Despite the credit crunch, efforts should be made to ensure that microentrepreneurs have access to credit. Access to credit will increase

---

[234] Booth, *supra* note 1, at 363.

[235] Lower estimates put the number living in poverty at thirty million to seventy-nine million. *Id.* Given that many people are hovering close to the poverty line, the 100 million figure may be more realistic. *Id.*

[236] *Provinces Told to be Active in Fighting Poverty*, JAKARTA POST, Dec. 18, 1999, *available in* LEXIS, World News Database.

[237] Wayne Arnold, *Foreign Aid Donors Approve $4.7 Billion More for Indonesia*, N.Y. TIMES, Feb. 3, 2000, at C4.

[238] *Letter of Intent of the Government of Indonesia—Addressed to Michael Camdessus, Managing Director of the IMF* (Nov. 13, 1998), *available in* IMF website (visited Oct. 6, 2000) <http://www.imf.org>. The IMF has recognized that economic reforms need to be broad-based and deep to achieve high-quality growth. It recognizes the importance of having adequate social safety nets in place to cushion the effects of economic reform, good-quality government spending (including allocations for health and education), and good "governance" (no tolerance for corruption; openness in policymaking). David D. Driscoll, International Monetary Fund, *What is the International Monetary Fund?* (last modified Sept. 1998) < http://www.imf.org/external/pubs/ft/exrp/what.htm>.

[239] The Virtual Library on Microcredit, *Microfinance Country Information: Indonesia* (visited Oct. 6, 2000) < http://www.gdrc.org/icm/country/asia-indonesia.html>.

[240] The World Bank, *Indonesia—Macroeconomic Update* 13 (Mar. 20, 2000), *available in* World Bank Website (visited Oct. 6, 2000) <http://www.worldbank.org>. The percentage of workers in the informal sector rose from 62.8% in 1997 to 65.4% in 1998. *Id.*

personal incomes and create employment.[241] It will be a means to shift people out of poverty and back into the formal sector.[242]

B. *The Need for Increased Government-sponsored MFIs*

Today, Indonesia's experience with state-run microfinance intermediation has heightened significance as the country pulls itself out of a severe economic depression. Indonesia should apply the knowledge and experience gained through the BRI-UD, BKK, and BKD programs when establishing new MFIs. These programs share several of the same policies and practices, namely concerning collateral, interest rates, savings mobilization, repayment incentives, and supervision, that have accounted for much of the programs' success throughout the areas they serve.

1. *Collateral Substitutes*

Newly formed state-sponsored MFIs should incorporate collateral substitutes in their lending model. The BRI-UD, BKK and BKD programs have all devised means to extend credit without requiring physical collateral. Most of these programs rely on character references to determine the creditworthiness of a borrower.[243] As the high repayment rates of the programs indicate, this method is an effective way to screen for loan eligibility. By lending based on character references, the programs are able to reach clients who are otherwise ineligible for assistance from formal financial institutions.[244] This policy facilitates delivering financial services to the truly poor. With the increased number of poor in Indonesia, new MFI programs should be focused on outreach to all of the poor and should adopt practices, like collateral substitutes, which will facilitate such outreach.

Though the use of character references has effectively secured loans made by the BRI-UD, BKK, and, BKD programs, new MFIs should understand that the effectiveness of character references depends on the importance of maintaining one's character within his or her community.[245] The programs surveyed operate in communities that are traditional and

---

241 *See* discussion *supra* Part III.B.4.

242 As opposed to the informal sector, formal sector employment includes employment that is part of the regulated economy.

243 All of the programs substitute character references for collateral, except for the SK-BKK, which requires a borrower to put up an automobile or land to secure loans over Rp200,000.

244 For a discussion of lending based on character references, see *supra* Part II.C.1.b.

245 For example, for the BKK in Central Java, clients' interests in maintaining their character within a small tight-knit community induce them to repay loans on time. Riedinger, *supra* note 73, at 306.

tightly knit. Social pressure has an impact on individual behavior in such communities.[246] Absent such community conditions, relying on character references may not be sufficient security for a microcredit loan.[247]

2. *Interest Rates High Enough to Cover the Cost of Services*

The new MFIs should charge interest rates high enough to cover their cost of services to become financially self-sustaining organizations.[248] As long-term viability and financial self-sustainability are integral for a MFI's success, MFIs must take steps to eliminate their dependence on donor subsidies.[249] As the BRI-UD, BKK, and BKD programs indicate, higher-than-market interest rates will not deter poor clients from borrowing funds.[250] Even if the interest rate that a MFI charges to effect full cost-recovery is considerably higher-than-market, the rate will likely be substantially lower than the astronomical rates charged by moneylenders.[251] Furthermore, charging a relatively high interest rate will eliminate the incentive for wealthier clients to pursue cheap credit.[252] The available funds, in essence, will be earmarked specifically for poor clients.

3. *Savings Mobilization*

To emulate the success of a MFI like BRI-UD, new MFIs must aggressively mobilize savings from their clientele.[253] As the data from BRI-UD indicates, if enough client savings are mobilized, donor subsidies can be eliminated.[254] In addition to boosting the financial stability of the MFI, mobilized savings can also benefit the client. Over time, clients can self-fund their business activities with his or her accumulated deposits. Furthermore, deposit accounts can also provide a buffer to poor clients when they hit hard times and are strapped for cash. A MFI should pay careful

---

[246] *See* discussion *supra* Part III.B.1.

[247] The use of character references in urban units of the Central Java BKK proved to be ineffective. Clients in these areas lacked social cohesion and the unit management was often corrupt; village heads would often approve loans to transients for a fee. Riedinger, *supra* note 73, at 307.

[248] For a discussion of the relevance of sufficient interest rates, see discussion *supra* Part II.C.1.c.

[249] *See* KHANDKER, *supra* note 12, at 84; Riedinger, *supra* note 73, at 307.

[250] *See* Riedinger, *supra* note 73, at 305-06; Charitonenko et al, *supra* note 110; Ravicz, *supra* note 8, at 29.

[251] KHANDKER, *supra* note 12, at 2.

[252] YARON ET AL, *supra* note 24, at 26.

[253] For a discussion on the importance of savings mobilization, see discussion *supra* Part II.C.1.d.

[254] *See* discussion *supra* Part III.A.

attention to establishing trust with the depositor since trust is essential to the promise of repayment.[255]

4. Incentives for Repayment

Any new MFI must build incentives for repayment into their lending model. Where a MFI cannot fall back on collateral to cover the costs of default, it is essential to maintain incentives that will facilitate a high repayment. The BRI-UD and BKK programs both provided access to larger loans in the future as an incentive for timely repayment.[256] The BRI-UD further incorporated an interest rebate incentive, paying back a portion of the interest paid if all payments were made on time.[257] This "carrot" method has proven to be successful and proves that availability of loans is of great importance to borrowers. New MFIs need to adopt similar incentives in order to keep the number of loan defaults at a minimum and prevent decapitalization of its lending funds.

MFIs should also adopt staff incentives to maintain high repayment levels. All of the state-run programs mentioned above have distributed bonuses based on staff members' ability to maintain healthy loan portfolios and collect timely payments. Loan performance-based incentives encourage loan officers to be more careful in their selection of borrowers, and furthermore, encourage the officers to remain in close contact with the borrower. By including staff in the loan repayment scheme, the MFI "wins" by achieving higher repayment rates, while the client "wins" by having an open channel of communication with the loan officer.

Failure to institute staff incentives may have a detrimental effect on an MFI's activities. For example, the BKD program has encountered problems because there are insufficient incentives for part-time staff to maintain a healthy loan portfolio. Though staff performance incentives are offered to increase the number of clients and maintain high repayment rates, the BKD have difficulty expanding their clientele base. Since most employees have other jobs and only conduct loan transactions once a week, they usually lack the incentive to expand the volume of their business or diversify their clientele. This has, unfortunately, led to BKD units making loans to the same small pool of clients.[258] BKD units could better leverage their informal

[255] *See* Fiebig et al., *supra* note 32, at 4.

[256] Charitonenko et al., *supra* note 110; Riedinger, *supra* note 73, at 306; Ravicz, *supra* note 8, at 35.

[257] LEDGERWOOD, *supra* note 3, at 245.

[258] Ravicz, *supra* note 8, at 80. BKD programs lack the inherent drive to become larger and to reach more clients. *Id.*

position within villages by creating staff incentives to reach new clients. This could be accomplished by, for example, hiring one full-time loan officer who would have to rely on an increased number of clients and higher rates of repayment to earn a larger bonus.

5. *Prudential Supervision by a Government Bank*

The newly-formed MFIs should be supervised by a government or commercial bank.[259] Past successful programs owe their success not only to their grass-roots focus, but also to their supervision by formal institutions.[260] With supervision, the MFIs are forced to adhere to formal financial reporting requirements. Formal data, in turn, facilitates analysis of a MFI's financial condition.[261] Depending on formal financial institutions for supervision while maintaining financial autonomy would permit new MFIs to tailor their services to the needs of clients while ensuring that their activities are not financially unfeasible.[262] Supervision would also provide security for depositors who entrust their money with MFIs.[263]

6. *Control of Corrupt Officials*

In forming these new MFIs, the government must ensure that funds are not siphoned off by corrupt officials.[264] The fate of the BRI-UD following the Asian Financial Crisis raises issues that new MFIs should address in their formation. The BRI-UD has not survived the financial crisis intact. Because the UD were a profit unit within the larger BRI, the UD have suffered from the cross-subsidization of BRI's commercial lending activities. Wealthier clients of the BRI have not maintained high repayment

---

[259] Due to the current banking crisis, it may take time for the banks to recover and reestablish themselves as institutions capable of overseeing an MFI's operations.

[260] *See supra* Parts III.A, III.B.1, III.B.2. & III.B.3.

[261] In surveying MFIs in East Asia, the SBP found that many MFIs do not adhere to financial reporting standards and, thus, could not provide accurate data on their activities. *Sustainable Banking with the Poor—a World Bank Project*, *supra* note 119.

[262] Like the BKK in Central Java, MFIs could rely on banks for technical expertise while retaining the freedom to adapt their services to clients' lending needs. *See supra* Part III.B.1.

[263] Art. 16(1) of the 1992 Banking Law was enacted because, "the collection of funds from the public by any party is in principle an activity that must be supervised" for the benefit of those who deposit funds. Elucidations to the Act of the Republic of Indonesia No. 7 of 1992, art. 16, *reprinted in* BINHADI, *supra* note 220, at 451.

[264] In February 2000, the disbursement of $4.7 billion (as part of the larger aid package) was made contingent on Indonesia's cooperation in eliminating rampant corruption. There have been reports of widespread "leakage" (official corruption) of aid funds. Wayne Arnold, *Foreign Aid Donors Approve $4.7 Billion More for Indonesia*, N.Y. TIMES, Feb. 2, 2000, at C4.

rates.[265] Corrupt practices indicate where BRI and its UD's profits have likely gone.[266] The Indonesian Bank Restructuring Agency ("IBRA")[267] has begun to take over BRI and to start its restructuring. It has taken over more than $80 million of BRI's bad debts.[268] Recapitalization of the bank is expected to cost over $400 million total.[269] IBRA intends to restructure BRI to focus on micro-scale lending.[270] After the restructuring is complete, IBRA is planning an initial public offering for BRI.[271] IBRA is hoping to attract foreign investors by selling an institution focused primarily on small and medium-scale business or farming activities.[272]

The government's mass financing of KUDs highlights its shortcomings with respect to controlling official corruption. With the KUDs' poor reputation, one wonders whether the government is wasting valuable resources by pumping large amounts of money into organizations that do not effectively serve the financial needs of poor clients.[273] With the KUDs taking up a large part of government funding, the environment is not one conducive to the proliferation of NGO MFIs.[274] The government must eliminate corruption within the KUD or should focus its funding efforts on programs which are not tainted by corruption.

Though no new MFI will reach the size of the BRI anytime soon, the BRI's experience warns that improvident policies can cripple an institution. The BRI's experience shows that unless official corruption is controlled, vast amounts of money could be sunk into loans destined for default.[275] Furthermore, the BRI experience indicates that poor borrowers, who repay

---

[265] Charitonenko et al., *supra* note 110.

[266] A recent inquiry brought to light BRI's loan to the Texmaco group amounting to $754 million. The loan was obtained through the intervention of Soeharto, in violation of a rule requiring prudent management of the country's foreign exchange reserves. *Indonesian Govt Hopes IMF Would Not Delay Loan*, XINHUA (Mar. 17, 2000), *available in* LEXIS, Emerging Markets Datafile.

[267] Established by Presidential Decree No. 27/1998, Indonesian Bank Restructuring Authority has the authority to conduct, control, develop, improve solvency, and restructure banks declared unsound by Bank Indonesia (the central bank). Presidential Decree No. 27 of 1998, art. 2(b).

[268] *Government plans IPO for BRI*, THE JAKARTA POST, Feb. 16, 2000, *available in* LEXIS, World News File.

[269] *Id.*

[270] Interestingly, the article states that the shift of operations toward micro-lending signals BRI's return to its core activities. Furthermore, the article attributes BRI's financial difficulties to "venturing into corporate loan activities." *Id.*

[271] *Id.*

[272] *Id.*

[273] Presumably, since the KUD is a state-run organization, "corruption" and "inefficiency" indicate that funds are being siphoned off by corrupt government officials and their cronies.

[274] The development of the KUD system has also diverted resources away from further development of the BKD system. The government has discontinued plans to expand the BKD system out of fear that the BKD's microfinance activities would compete with the activities of the KUD. Ravicz, *supra* note 8, at 27.

[275] *See supra* note 155 and accompanying text.

their loans on time and deposit their excess savings, may bear the burden of wealthier clients with poor repayment histories because of poor policy decisions by management of the larger institution.[276] In order to prevent institutions from making policy decisions that disadvantage poorer clients, MFIs should only provide microfinance services.[277] They should not engage in commercial financing and, thereby, incur unnecessary risks for their clientele.

C. *The Need for Increased NGO Activity in Microfinance*

Despite the success of state-run MFIs, the current financial crisis highlights the need for a more dynamic microfinance environment. Indonesia has shown that it knows how to create sustainable state-sponsored MFIs, like the BRI-UD, BKK, and BKD. However, the success and invigoration of state-run organizations has overshadowed and often displaced NGOs from participating in microfinance intermediation.[278] The devastation of Indonesia's formal financial system indicates that more NGO participation in microfinance services would lead to a healthier microfinance environment for the country's people.

While the PHBK program is evidence of steps taken by the Indonesian government to incorporate NGOs in the provision of microfinance services, NGO activities through the PHBK program have very high program costs.[279] These high costs require a much larger government subsidy than independent units like the BKK or BKD. As of 1995, the SK-BKK had to charge 64% annual interest to operate without donor subsidies.[280] In comparison, NGO lenders in the PHBK program would have had to charge 277% to operate without such aid.[281] An NGO operating independent of the PHBK could avoid the large overhead costs attendant to its multi-layered credit delivery scheme. If the government channeled funds directly into NGOs as it does into BKDs (initial capitalization),[282] NGOs could deliver financial services without the intermediate steps that add to program costs.

---

[276] *Id.*

[277] By focusing efforts on microfinance, an MFI would not have to worry about its assets cross-collateralizing large commercial loans.

[278] Few NGOs are involved in microfinance in Indonesia. *See supra* Part III.C.

[279] Ravicz, *supra* note 8, at 20. The program costs are high in PHBK because of the multiple organizations involved in the lending scheme. First, the rural bank or BPD makes a loan to the NGO. The NGO then loans to a borrowing group, and the borrowing group finally disburses funds to its members. A simpler, more direct model would presumably cost less to administer. *Id.*

[280] *Id.* at 15.

[281] *Id.*

[282] *See* discussion *supra* Part III.B.3.

Furthermore, allocating funds directly to NGOs would appear to be more cost-efficient than channeling funds through expensive programs like the PHBK.

1. Why an Increase in State-run MFIs is Not Enough

The absence of NGO MFIs in Indonesia is felt when complaints about government microfinance programs are voiced. In October of 1998, the Indonesian government announced that it had allocated $1.3 billion to fund microcredit schemes designed to help small and medium enterprises ("SMEs") and cooperatives.[283] Yet by December, critics and advocates of SMEs had observed that the bureaucratic barriers, including requirements for collateral, business licenses, tax registration numbers, and business location permits, had made it very difficult for SMEs to qualify for the loans.[284] Banks, through which the credit was channeled, were not disbursing funds, and the alternative (government disbursement) would likely have led to collusion and disappearance of funds.[285] These stories, coupled with incidents of official corruption in state banking such as the Texmaco loan, suggest that a third party non-commercial NGO operating locally might be better able to ascertain its clients needs and deliver the credit needed without requiring clients to wade through layers of bureaucracy.

Alternatively, more flexible organizations are needed to reach the poorer clientele that the BRI-UD are simply failing to serve. The increase in loan amounts indicates that the BRI-UD, the largest state bank with the most extensive branch network, may not be reaching the poorest clients in need of microfinance services.[286] To the BRI-UD's credit, it has recognized that smaller borrowers have been gradually excluded from lending activities, and, to rectify the situation, it now offers a smaller scale KUPEDES product,

---

[283] *Observers Skeptical Over Micro Credit Schemes*, JAKARTA POST, Dec. 14, 1998, *available in* LEXIS, World News Database.

[284] *Id.*

[285] *Id.*

[286] A commonly used measure to assess the outreach of a microfinance program is to look at the ratio of loan size to GDP per capita. In 1995, the average loan size to GDP per capita for loans extended by locally-based MFIs (BKK and BKD) ranged from seven percent to ten percent. In comparison, BRI-UD had an average loan size of 89% of per capita GDP. *See* Ravicz, *supra* note 8, at 19. BRI-UD's outreach to the poorest segments of the population is also questionable based on the percentage of its borrowers who are female (24%). In comparison, women account for 40 to 62% of borrowers of the locally-based MFIs. *See* Ravicz, *supra* note 8, at 20; Boomgard & Angell, *supra* note 130, at 222. The collateral requirement for loans also affects the BRI-UD's ability to reach the poorest of the poor. Nelson, *supra* note 37.

which has a maximum loan amount of $215.[287] Increased NGO participation in the provision of financial services would permit the creation of an organization designed to serve solely the very poor, for example, by facilitating the offering of credit based on a group liability scheme rather than on collateral requirements.

Anecdotal evidence that state-run MFIs are not adequately reaching poorer clients who need financial services further points to the need to develop additional NGO MFIs. In interviews conducted by the Rural Development Institute on Java,[288] rural farmers from four villages stated that credit was not available. When asked about the availability of loans through the BKK, respondents stated that the collateral requirement was a barrier. Respondents also stated that though the BKD offered credit, the weekly payments were too high, especially in light of their limited cash flow.[289] The interviews also revealed that women do not use the state-run MFIs and suffer acutely from the lack of credit. Although state-run MFIs must adhere to their models of lending that implicate collateral requirements and short-term pay periods, smaller NGO MFIs could tailor their loan products specifically to suit the needs of their clientele. NGOs would have the advantage of serving a smaller number of clients and, thus, could offer loan products with a different security scheme or payment plan. Furthermore, some NGOs could further target female clients, alleviating their alienation from more traditional, state-provided sources of credit.

Furthermore, increasing NGO activity in microfinance could help extend microfinance services to the outermost regions in Indonesia. Though the BRI-UD and BKK have penetrated much of the country with offices in subdistrict capital towns, there are still many villages far out of reach from these towns.[290] Though the programs utilize traveling staff to reach those who cannot reach the village or capital town offices,[291] a smaller NGO could dedicate its efforts to one or two outlying towns and bring services regularly, rather than on a weekly basis like the BKD. If a NGO were solely devoted to a smaller remote town, it also would not have to incur the regular costs of traveling to and from a distant office. In addition, because of their proximity to their clientele, NGOs could operate with a closer understanding of their

---

[287] McGuire et al., *supra* note 128, § 2.1.

[288] Interview with Michelle vanLeeuwen, Staff Attorney, Rural Development Institute, Seattle, Washington (May 5, 2000).

[289] Farmers stated that they needed a longer payment period. *Id.*

[290] McGuire et al., *supra* note 128, § 5. The Central Java BKK's 510 unit offices reach only half of the province's 8,500 villages. Riedinger, *supra* note 73, at 305.

[291] Riedinger, *supra* note 73, at 304.

clientele that could help in designing products and services most suitable for them.[292]

The government should broaden its support for microfinance activities by funding more NGOs to become financial intermediaries. NGO MFIs are necessary to fill the gaps in outreach of state-run MFIs and, furthermore, are needed as fall-back institutions when the banking system is crippled.[293] Like newly-formed, state-run MFIs, newly-instituted NGO MFIs should follow the prudent policies and practices outlined above. Because NGOs have no direct link with the government, supervision will have to be handled in a different manner.[294]

Ideally, an NGO could form a relationship with the BPD in the region where it operates and have the BPD oversee its financial operations.[295] While maintaining control over its daily operations, the NGOs could turn to the BPD for occasional training and guidance on policy decisions. In return for the supervisory services, NGOs could pay a fee for the services or agree to deposit their excess savings with the BPDs. Alternatively, NGOs could make arrangements with a local BRI branch. Providing supervision and occasional training to NGOs could become a lucrative side operation for the BPDs or BRI branches.[296]

NGO involvement in microfinance cannot develop healthily unless NGOs are permitted to mobilize savings from its members.[297] The appeal of microfinance as a poverty reduction strategy is in its ability to operate without government or donor subsidy. As the experiences of the BRI-UD and BKK indicate,[298] joining the elite rank of financially-viable MFIs requires mass mobilization of savings deposits. Unless Indonesia changes its laws regarding the ability of NGOs and other small financial institutions to collect deposits, most of those programs will have unsure futures.[299]

---

[292] Nelson, *supra* note 37.

[293] Though the entire country was hit by the Asian financial crisis, one wonders whether currency speculation in the Rupiah could have wreaked as much havoc on small-scale institutions as on large formal institutions.

[294] NGOs are not subject to reporting requirements or taxation. McGuire et al., *supra* note 128, § 3.1.

[295] The BKK programs and the BKD work symbiotically with larger organizations, the BPD and the BRI, respectively, in their region. Riedinger, *supra* note 73, at 302; Ravicz, *supra* note 8, at 76-77.

[296] Taking on this role should not be burdensome for BPDs or BRI branch offices. Both organizations have plenty of experience with supervising MFIs in a quasi-regulatory way, i.e., the BRI-UD, the BKK, and the BKD.

[297] Savings mobilization is essential for a microfinance program to become self-sustaining. KHANDKER, *supra* note 12, at 8.

[298] *See* Riedinger, *supra* note 73, at 305; Charitonenko et al., *supra* note 110.

[299] Though banking laws are designed to protect depositors, they are often drafted with banks with large portfolios in mind. The practical effect of such laws on smaller financial intermediaries, such as NGO MFIs, is to impose standards that are impossible to meet for institutions with small or informal-type loans. Nelson, *supra* note 37.

Though mobilization of small deposit amounts appears to be tolerated,[300] a clear statutory provision permitting NGOs to mobilize deposits would greatly boost NGO MFI activity. NGOs could operate knowing they had the opportunity to obtain long-term viability and financial self-sustainability. While the government's concerns about savings mobilizations by NGOs are understandable, these fears should be allayed if a NGO is subject to supervision by a government bank.[301]

2. *Creating a Regulatory Framework Supportive of NGO MFI Activities*

Increasing the number of NGO MFIs in Indonesia will require adjustments to the regulatory framework that currently governs them. Currently, NGO MFIs are subject to two regulations that may affect the scope of their operations. First, the 1992 banking regulation affects the ability of some NGOs to operate as rural banks capable of accepting deposits.[302] Second, NGO laws prohibit NGO MFIs from accepting deposits from members.[303]

The limitations imposed by the 1992 banking regulations coupled with the limitation on NGO deposit mobilization create little working room for small microfinance providers wishing to operate in Indonesia. A small microfinance provider, without the requisite $21,400 to form a rural bank, cannot start a credit and savings service and be confident that it will become financially sustainable.[304] While neither the 1992 banking regulation nor NGO regulations limit an organization's ability to extend loans, the inability to mobilize deposits destroys any MFI's ability to become self-sufficient.[305]

A sustainable institution is not an end in itself; it is also a key to successful loan repayment performance. As Indonesia's state-run organizations indicate, the small loan amounts involved in microcredit make foreclosure cost prohibitive. The BRI-UD, BKK, and BKD are able to induce repayment by ensuring that future loans in larger amounts will be available if loans are repaid on time. The reason this incentive induces

---

[300] McGuire et al., *supra* note 128, § 3.1.

[301] Since NGOs are not subject to reporting requirements, the government is presumably concerned with protecting clients who place deposits with NGOs. Robert Christen & Richard Rosenberg, The Consultative Group to Assist the Poorest, *The Rush to Regulate: Legal Frameworks for Microfinance* 1, Occasional Paper No. 4 (Apr. 2000) (visited Oct. 8, 2000) <http://www.cgap.org/assets/images/En4occ.pdf>.

[302] Ravicz, *supra* note 8, at 4.

[303] McGuire et al., *supra* note 128, § 3.1.

[304] The law will not permit such an entity to accept deposits. *See* discussion *supra* Part III.C.

[305] For a discussion of the significance of savings mobilization in microfinance, *see* discussion *supra* Part II.C.1.d.

repayment is because clients are confident that the institution will be around when they need to borrow money again. Should an institution's stability be shaky due to insufficient assets or deposits, clients are less likely to believe that the incentive (future loans) will be available and, thus, are less likely to repay their loans. Hence, by foreclosing the ability of small MFIs and NGOs to shore up their assets by taking deposits, the current laws may be endangering the healthy repayment culture maintained so far in microfinance in Indonesia.

To bolster smaller institutions or NGO MFI involvement in Indonesia, the laws limiting their abilities to collect deposits should be changed. If the governmental concern is with supervision of organizations that mobilize deposits, the banking laws prohibiting savings mobilizations from small institutions should permit an exception to the rule for organizations retaining the supervisory services of a government bank, like the BPD. This informal means of regulating smaller institutions would give these institutions the opportunity to become financially viable and save the government from having to institute a formal regulatory framework overseeing all small financial institutions. Alternatively, if the government is seeking to address concerns over the low capitalization of some small institutions, it could permit another exception to the rule by permitting institutions to obtain guarantees for the amount that they are undercapitalized. If Indonesia is to remain a leader in microfinance, it must find an alternative way of regulating smaller MFIs.

The Indonesian government appears to be moving towards including NGOs in poverty reduction strategies. In May of 1999, Indonesia passed a law granting each province considerable autonomy in regulating matters other than those of national concern.[306] Each province will be responsible for poverty alleviation in its area and will set its own poverty alleviation targets and policies to deal with the problem.[307] This law is intended to make NGOs active participants in the nationwide poverty alleviation effort.[308] Should this law be effectively implemented, NGOs may finally have the much needed boost to participate in microfinance.

---

[306] The Act grants provinces authority to administer all areas of government except foreign policy, defense and security, judiciary, and monetary and fiscal policy. Act of the Republic of Indonesia, No. 22 of 1999, art. 7(1).

[307] *Provinces Told to be Active in Fighting Poverty*, *supra* note 236.

[308] *Id.*

VI. CONCLUSION

Indonesia can take its microfinance environment to the next level of achievement by increasing the outreach and number of its state-run MFIs and by integrating more NGOs into the provision of microfinance services. It should do so by eliminating legal barriers to NGO participation in both savings and credit services provision. Whether expanding microfinance through state-run MFIs or through NGOs, organizations should adhere to the policies and practices that have been shown to increase the likelihood of success for an MFI. New MFIs should be wary of political corruption, especially if is a state-run programs.[309] Increased NGO involvement could reduce the clients' political risk in microfinance intermediation by offering an opportunity to bank with a non-state-owned MFI. Furthermore, though the state-run institutions have penetrated successfully at the village level, further efforts to reach those in the outermost regions are needed. Smaller NGOs with operating flexibility may be better suited for reaching these populations.

Microfinance is a proven way to reduce poverty among the world's poor. Indonesia has successfully shown how microfinance can be delivered effectively and in a financially sustainable manner. Because the poverty level has skyrocketed in Indonesia in the last two years, microfinance should play a part in helping people work their way out of poverty. Services should be delivered through a synergistic mix of old and newly-formed, state-owned MFIs and microfinance-focused NGOs.

---

[309] As the operations of the BRI shows, a state-run program may be subject to political corruption and, as the BKK has show, political pressure to forgive loan repayment. *See* Ravicz, *supra* note 8, at xi ("BKK and LKP faced pressures to relax their underwriting and collections efforts during the 1992 elections...").