Understanding the Role of Bank Relationships, Relationship Marketing, and Organizational Learning in the Performance of People's Credit Bank

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2007

Chapter 3
MICROFINANCE INSTITUTIONS IN INDONESIA

This chapter briefly explains the general existing conditions of microfinance institutions (MFIs) in Indonesia, especially in Central Java. Researchers have their own ways to explain the existing conditions of MFIs. The explanation of MFIs here will be more focused on and relevant to licensed BPRs and the external environment that has influenced the BPR development recently. This chapter is a highlight to better understand the following chapters. In explaining MFIs in Indonesia, researchers are always faced with secondary data which is not readily available; and there is not any single central body to collect, process, and disseminate MFI data to update available data at the moment. The issue of data availability can be seen through comments from the ProFI Microfinance Study (*www.profi.or.id*), Steinwand (2001:13), and MFI data of Directorate of BPR supervisor, the Bank Indonesia.

The location aspect of a financial business, whatever the core competence, is a strategic decision. Section 3.1 describes some location aspects of BPR. Section 3.2 and 3.3 show that the aftermath of the economic crises, aggregate BPRs proved their superiority which had proven that aggregate BPRs never had negative net worth capital and they were able maintain their intermediary function. At the same time commercial banks desperately experienced negative net worth and slow recovery in their intermediary fuction.

Section 3.4 discusses the business climate of the microfinance industry under rapid environmental changes. The focus of the explanation is on competition in the microfinance market, including the players involved and the degree of competition. These points have not been addressed before. Competition between players in the microfinance market is expected to increase overtime. The co-existence of subsidized and commercial loans is a regular part of banking, even though the current trend is moving toward more market based lending. The entry barrier for the MFI industry is actually low, even though Bank Indonesia had added a more difficult entry barrier for BPR.

Besides the presence of commercial banks, the business climate in the microfinance market arena are also driven by the ongoing banking system facilities such as deposit insurance institutions, credit guarantee institutions, preparation of Apex bank (since 2002), rating agents and credit bureau proposals (since 2002), MFI act proposal (since 2001), and the recent merger wave of the biggest BPR group in Central Java, that is the BKK Group. This change is now in progress and it will influence the present and the future of the microfinance market. Section 3.5 briefly describes dual banking systems : the conventional and sharia systems.

3.1 Geographic Distribution and the Nature of Locality

Bank Perkreditan Rakyat (BPR) is the generic name of a diverse small-scale unit bank - one type of microfinance institution in Indonesia. Bank Indonesia classifies it as a "rural credit bank". The Directorate of Economics and Monetary Statistics of Bank Indonesia Jakarta divides the rural credit banks into three sub-groups namely: (a) BPR non-rural, i.e. new BPRs, petty traders/village banks, BKPD, and employee banks, (b) BPR rural, i.e. village banks, *paddy banks*, and (c) LDKP. Meanwhile, the Monetary Economic Statistics Section of Bank Indonesia Semarang classifies them differently: i.e., the rural credit banks consist of (a) BPR, and (b) others (BKD, LDKP, etc. Seibel and Parhusip (1998) in their case study of BPR Shinta Daya Yogyakarta name it as a self-financed private-village bank or rural bank. These names or labels give an image that private shareholders own these small-scale banks and they are situated in rural geographic locations. Steinwand (2001:20) provides a further historical overview and detailed discussion of BPR concept. Moreover, he (2001:309-321) reviewed the 100 year history of BPR in which he identified that a BPR's development during the colonial period as well as the policies placed on it were guided by the following three assumptions:

1. The rural population has a "chronic credit thirst" and is too poor to save.
2. Rural financial institutions can offer comparable services considerably cheaper than the usurious moneylender.
3. Within the establishment of rural financial institutions, the "cancer of usury", i.e. the moneylender, can be eradicated.

He criticized the weaknesses of these assumptions, which do not match entirely to the current situation. However, he did not implicitly object to the implication and image of the "rural bank" label. Instead, he let the audience see BPRs' operations with a new vision.

The classical view or "myth" of BPRs as rural banks gives a misleading image in some degree of understanding, especially to those who are not familiar with their real life. BPRs cover various types of organizational settings and have diversification in location of origin. It is agreed upon that one kind of BPR is labeled properly as rural banks e.g., BKD, LDKP, etc., which are owned by village governments. In general, bigger sized MFIs are urban based (or urban biased). Even in BRI Units, the “giants” or the “market leaders” in MFIs tend to be urban biased as well. Martokoesoemo (2001:83) disclosed the fact that BRI shifted its strategy to remedy the losses BRI village units accumulated from 1970 to 1985, which accounted for Rp. 76.6 billion, by moving their offices from the rice centers (rural or village area) to the sub-district business centers (markets). The name BRI Unit Desa means the BRI village/rural unit has been replaced by the BRI unit. Initially, BRI was established in a big city, Purwokerto, for employees who were not in a rural area. Other BPRs, those which were established before the banking deregulation package on October 28th, 1988, under the generic name “market bank”, remain situated as close as possible to markets (urban business districts/areas) and are owned by both private or local/regional governments. The newest BPRs, which were established after 1998, cluster in central business locations, both in the regencies and urban districts that have better business prospect. After Presidential Decree No. 71 was passed in 1992, MFIs non BPRs were directed to covert to BPRs by upgrading themselves to meet BPRs standards, among others, to raise their paid-up capital to a minimum of Rp. 500 million; otherwise, by October 1997 they would not be regarded as deposit-taking institutions. The outcome of the conversion, there was additional 1,350 “new” BPRs. Along with the conversion status, this regulation led to the growth of “rural” banks in urban areas as close as possible to the business growth centers. From a business point of view, selecting the location is considered as a strategic decision for any size of financial institutions, including BPRs and commercial banks. Generally, banks prefer to be located in densely populated areas, despite the higher degree of marketplace competition than in sparsely populated areas that have lower competition away from business growth centers. The businesses are likely to incur heavy losses for poor choices. Business owners will deserve great attention, time and other resources to come up a deliberately location decision. In a broader perspective, the unbalanced distribution of MFIs on some islands in the country is rooted in them using location as a key strategic factor for their future business success.

Successive explanations in this section show the phenomena where Sumatra, Java, and Bali are favorite places for MFIs, since they are considered to have business growth centers. Java Island dominates Indonesia in terms of the number of MFIs, and particularly the BPR. More than 70% of total BPRs operate in Java. However, there is a decreasing trend of proportion of BPRs in Java. Bank Indonesia statistics (1991-2003) show the decreasing proportion figures from 87% (1991), 82% (1998), 79% (2002) and 72% (2003) respectively. The number of MFIs in Central Java is relatively unchanged in proportion and has the second largest number after East Java on Java Island.

According to the data compiled by GTZ-Profi[1], the number of MFIs on Java Island has reached 41,241 business units or 54.67% out of the total number of MFIs in Indonesia. Java Island holds about 59% of the population of Indonesia. The island has an area of 127,560 km^2 or 6.7% of the total area of Indonesia, where ± 55% of MFIs can be found. Furthermore, out of the distribution of 2,228 BPRs, 71.7% are on Java Island and 28,3% are on the other islands. The distribution of 36,376 savings and lending cooperatives (*koperasi simpan pinjam, KSP*) and savings and lending cooperative units (*unit simpan pinjam koperas, USP*) per December 2003 is 54% on Java Island. In Central Java there are 4,939 or 13.6% total KSP and USP. Central Java, which has an area of 32,564 km^2 or 1.7% of the area of Indonesia and a population of 32 million (5.1%), has approximately 8 % of the total MFIs.

Meanwhile, the geographic distribution of two emerging microfinance institutions in Indonesia: *BMT*[2] and *Swamitra*, seem to follow the distribution of BPRs. As of 2004, of about 42% (or 1.456 units) of BMT and 29%(or 160 units) of Swamitra cooperatives operate in Java. In Central Java, the Bukopin regional office in Semarang is in charge of 11 Swamitras and Solo's office handles 14 Swamitra units. While BMTs account for 447 units approximately 13% of total BMTs in Indonesia.

The nature of BPRs' locality can be traced from their ownerships, offices, and branch offices. Local investors, private or local government, own most of the BPRs. The reason is simple; they know more about their hometowns and their future prospects. The nature of BPRs' locality is also determined by rules and regulations, including:

(1) Working area: location of the main and branch offices

The deregulation package in October 1988 only allowed BPRs to open branch offices in districts that were adjacent to the district of its head office. The district here means that it is not situated outside the capital city of a regency or a province and state.

[1] GTZ-Profi (http://www.profi.or.id) collects information about MFIs, consisting of BPRs, cooperatives, credit unions, pawnshops, BMTs, BKDs, and microfinance divisions of commercial banks (incl. BRI units). The diverse years of publications and data are complied by Profi from various sources.
[2] BMT stands for Baitul Maal wat Tanwil, a sharia non bank microfinance institution.

Market banks, which are in big cities (commonly in capital cities), are not allowed to open branch offices, except if they are going to move to a district area. Presumably, the regulators (Bank Indonesia and the Ministry of Finance) have been preoccupied with the assumptions that (a) a BPR, which fits under the classification of a rural bank, will have its office in a rural area - including in a district area, and (b) the village people are credit hungry where BPR has to serve them.

In 1999, the regulators relaxed the location restrictions but imposed additional entry barriers, such as higher minimum requirements for initial capital, quality of governance and personnel, etc. The relaxation of location means BPRs are allowed to open branch offices everywhere, provided that the locations were in the same province with the main office and it fulfilled the additional paid-up capital as a requisite to open a new BPR in a specific location

Driving force changing in rule is biting critic from (a) BPR associations, (b) academic researchers, and (c) politicians aimed to regulator. In their opinion, BPR clients are from SMEs and low income households who live in both rural and urban locations. Regulator cannot impose rules that hinder BPR from serving the low level income society.

(2) Limited transactions

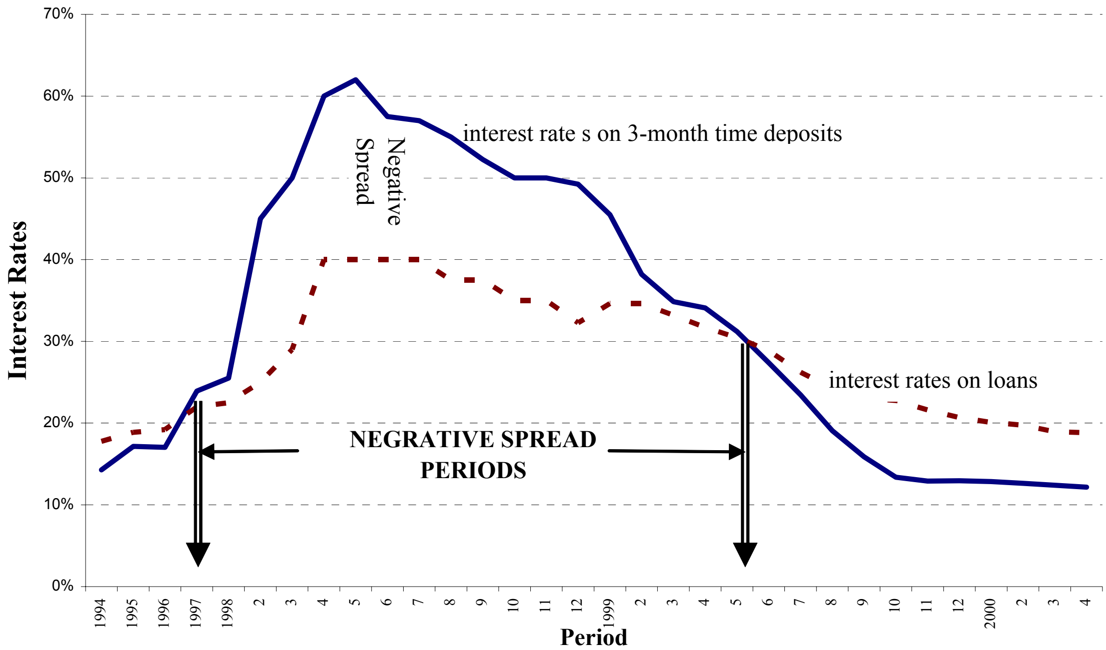
The BPR is not allowed to service in checking accounts (demand deposits) and fund transfers. The bank can only give credit, place the funds in other banks (commercial banks and BPRs) and collects time & savings deposits. BPR is allowed to do fund transfers for credit repayments, through inter-bank deposits. However, BPR is not allowed to charge client service fees from money transactions.

3.2 The Degree of Capital Resistance amid the Financial Crisis

Banks have an equity capital to cushion them against business risks. The macroeconomic shock in 1998 was due to a currency and imbalance of trade crisis intensified by other crises leading to business risks of banks which appeared as losses that should have been able to be absorbed in the capital. Shareholders are the ultimate residual claimants bearing the risks of the capital erosion they own. Frécaut (2004:41) estimates that of the total accumulated banking losses at around US $50 billion, approximately 90% came from only two sources: some US $35 billion (69%) from provisions for depreciation of assets, and approximately US$ 10 billion (20%) from negative interest margins. The provisions for depreciation of assets should correspond to provisions of non performing assets that mainly consist of credits. Commercial banks have a much bigger proportion of loan portfolios to conglomerates, the medium and large size of business. This loss consumed the capital, which then made important list of capital resistance of banks in the crisis period.

Although Bank Indonesia announced that negative interest margin (or negative spread) had ended in June 1999; the total capital of banks remained negative up to May 2000 (Figure 3-1 and Figure 3-2).

Figure 3-1: The Aggregate negative spread of the commercial banking system in Indonesia during the monetary crisis

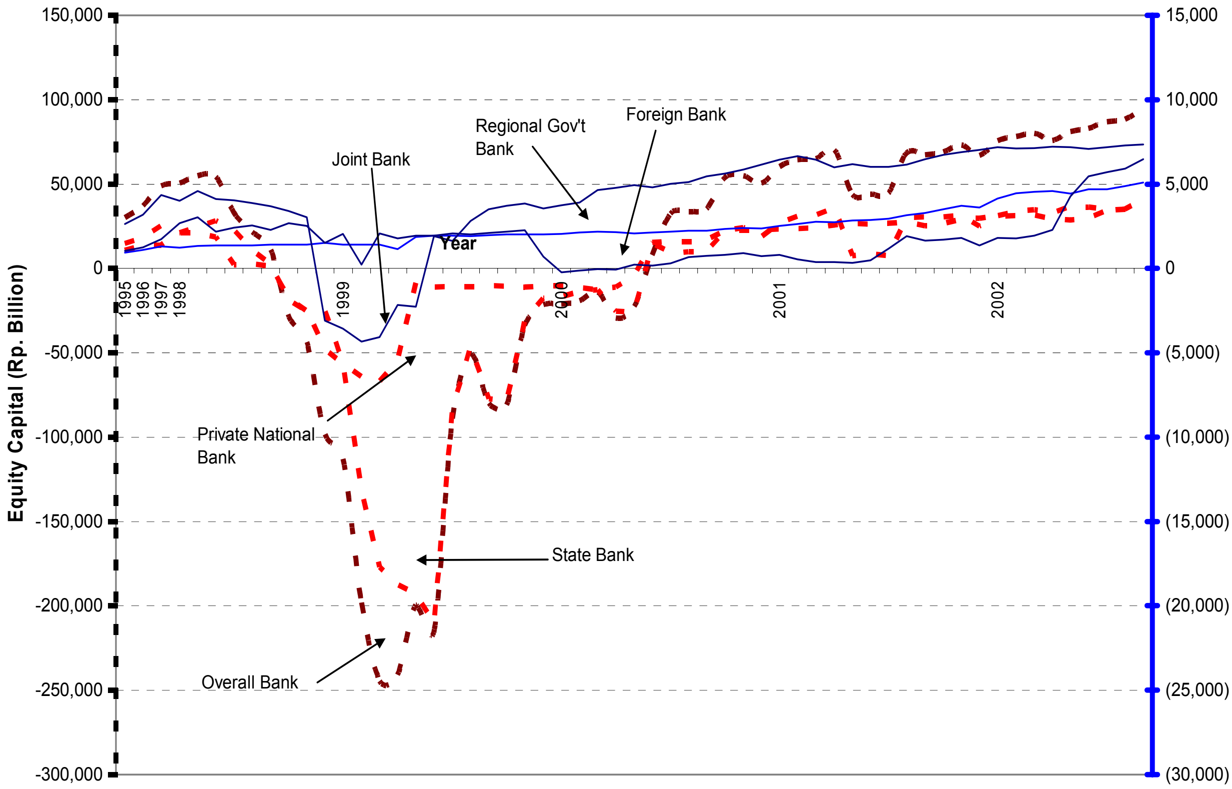


Source: Bank Indonesia statistics, author's graph

In aggregate negative interest margin (spread) is the second biggest sources of the loss for commercial banks, and at the same period, BPRs did not experienced it. Two categories of dominating commercial banks, i.e. state-owned banks and private national banks faced negative net worth for 20 months (Oct 1998 up to May 2000). Foreign and joint banks experienced negative equity for only 5 months (January-May 2000) and 6 months (Dec 1998-May 1999) respectively.

Figure 3-2 shows that negative net worth (market value of equity) occurred in June 1999. The decreasing net worth started in July 1999 and continued until June 2000. It was improved not only by positive spread, but also by recapitalizing 37 commercial banks starting in 1999, which reached Rp. 281.8 trillion (24 banks recapitalized in 1999), and its accumulation became Rp. 430.4 trillion (37 banks recapitalized in 2000). The macroeconomic shock from 1997/1998 to1998/1999 had huge negative impacts on the government, as it had to provide Rp. 628.6 trillion for the needs of (1) recapitalizing commercial banks, (2) the Bank Indonesia Liquidity Aid, (3) government guarantees and credit programs

Figure 3-2: Total net worth capital of commercial banks by ownership category (Rp. billion)



Source: Bank Indonesia statistics, author's graph

. The funds were provided by issuing government bonds that had amounts close to the deposits put in commercial banks. In general, however, commercial banks suffered the biggest impact of the macroeconomic shock as reported by the negative equity from the period of 1998 to 1999 (Table 3-1 and Figure 3-2).

Table 3-1: Some overall performance indicators of commercial banks in Indonesia as per December 31, 1998-2003

1= trillion Rp.

No.	Indicators	1998	1999	2000	2001	2002	2003
1	Total Assets	895.5	1,006.7	1,030.5	1,099.7	1,112.3	1,213.5
2	Credits	625.4	277.3	320.4	358.6	410.3	477.2
3	Deposits	545.5	617.6	699.1	797.4	835.8	888.6
4	Capitals	-129.8	-41.2	52.3	62.3	93.8	110.8
5	Net Interest Margin	N.a.	-38.6	22.8	37.8	42.9	49.5
6	Profit(Loss) before tax	-178.6	-91.7	10.5	13.1	22.0	26.4
7	NPL-Gross (%)	48.6%	32.8%	18.8%	12.1%	8.1%	8.2%
8	NPL- Net (%)	34.7%	7.3%	5.8%	3.6%	2.1%	3.0%

Source: Annual reports, Bank Indonesia

Note: LDRs reported by Bank Indonesia may be lower than these, e.g., in 2000 it was 33,4%, and in 2003 it was 43,5%. According to Bank Indonesia, the denominator of the LDR includes bank deposit, capital and its equivalence.

Respectively, the net worth of commercial banks as per Dec 31, 1998, and 1999 were negative Rp. 129.8 trillion and negative Rp. 41.25 trillion respectively. At the same time, the loss reached Rp. 178.6 trillion and Rp 91.7 trillion. Local banks such as regional development banks (BPD) and BPRs didn't experience the severe impact of the crisis on their net worth. Overall, BPDs had positive capital, but 12 out of 27 BPDs had to go under recapitalization as much as Rp. 1.2 trillion, including the Regional Development Bank of Central Java (BPD-Jateng). The BPD Jateng recapitalized Rp. 389.4 billion as per May 24, 1999. Per December 31, 1999, it had a reported loss of Rp. 502.5 billion.

Table 3-2: Some overall key indicators of BPRs in Indonesia as of December 31, 1997-2003

1= billion Rp

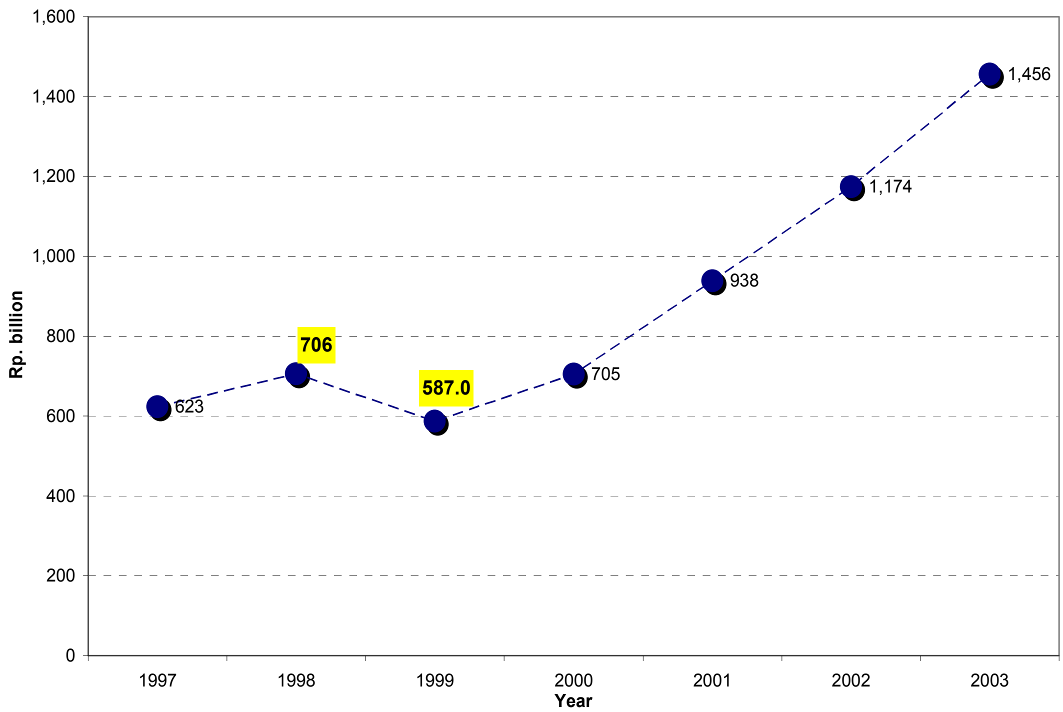
Description	1997	1998	1999	2000	2001	2002	2003
Total assets	2,944	2,982	3,462	4,731	6,474	9,080	12,635
Saving deposits	n.a.	613	850	1,190	1,574	2,002	2,617
Time deposits	n.a.	888	1,188	1,892	2,706	4,124	6,251
Total deposits	1,601	1,501	2,038	3,082	4,280	6,126	8,868
Outstanding loans	2,288	1,861	2,452	3,619	4,860	6,683	8,985
Borrowers	n.a.	1,479	2,199	1,672	1,560	1,825	1,993
Net Worth ("Equity")	623	706	587	705	938	1,174	1,456
Profits	30	(42)	7	116	223	338	429
LDR	n.a.	80%	80%	85%	81%	77%	74.5%
NPLS	n.a.	29%	22%	16%	12%	9%	7.9%
ROA	n.a.	-2%	0%	2%	3%	4%	3.4%
ROE	n.a.	-7%	1%	14%	20%	25%	24.9%

Source: Annual reports from Bank Indonesia, 1996/97-2004, Indonesian BPR Association – Perbarindo, 2004

Locally operated BPRs experienced overall losses in 1998 i.e. Rp. 42 billion (Table 3-2), but it didn't make the capital negative (Figure 3-3.).

Therefore, in conclusion it can be said that BPR has a strong degree of capital resistance in facing the monetary crisis. Though the aggregate BPRs didn't go through capital negative as what happened to commercial banks' capital, BPRs' capital decreased by Rp.121 billion from 1998 to 1999 until the capital position in 1999 was still positive at Rp. 587 billion. There were, however, a number of BPRs which had gone bankrupt from 1999-2002; 117 BPRs or 5.6% of BPR banks were closed down by Bank Indonesia. At the same time, 82 commercial banks or 32.8% of those banks were closed. As a direct consequence of the BPR closure, the Ministry of Finance had to pay a third party deposit, which accounted for Rp. 231.9 billion under the blanket guarantee scheme. This was the biggest exit event in the banking industry ever.

Figure 3-3: Total net worth capital of BPRs in Indonesia in 1997-2003
1= billion Rp.



Source: Bank Indonesia Annual reports, 1996/97-2004

Bank Indonesia investigated the causes of insolvent BPRs. During the investigation, BI identified some sources of the problem, among others, the increasing NPL, and white collar crime: fraudulent activities, while BI could not provide emergency funds to alleviate the heavy shortage of funds to BPR in compliance with Act Number 23/1999.

3.3 Recovery of the Financial Intermediary Function

The deposit and lending behavior of commercial banks and BPRs go at different paces to reach the ideal stage of a financial intermediary institution. Each category of banks behaves differently in responding to the macroeconomic crisis. Up until 2004, commercial banks have not been able to restore their main function as financial intermediaries, while BPRs were able to maintain their function without any significant disruption, in spite of the heavy financial crisis that hit them.

Despite the performance indicators of most commercial banks which reveal some improvement (Table 3-1) as shown by the increasing business activities such as total assets, credits, deposits, net interest margin, quality of credits (NPLs decreased) and bank capital, the commercial banks were unable to fully restore their main function as a financial intermediary. The intermediary function of a bank is measured by the loan to deposit ratio (LDR). Bank Indonesia standardizes the ideal LDR (best practice) with the value from 80% to 110%. If the LDR of a bank is in that position, the bank is considered to have a good intermediary function. A bank with an LDR < 80% reflects its under-lending position. The bank is in a position of over liquid. The idle fund can be invested in productive asset beyond the credit. In October 2002, the LDR of commercial banks remains low, as much as 37.1%, which is still far from expectations. Commercial banks only invest about 37.1% (Rp. 394.3 trillion) in loan portfolios out of the available deposits of Rp. 821.5 trillion. They remain in a position of disintermediation and have a resulting deposit surplus of Rp. 427.2 trillion. Banks placed the liquidity surplus in the commercial banking industry or in the risk-free Bank Indonesia certificates, inter-bank lending and government bonds. Surprisingly, commercial banks invest Rp. 421.4 trillion in government bonds. The slow progress in resuming (reviving) the intermediary function of commercial banks has been hampered by the low demand for credit and banks foreseeing high-perceived risk exposure in extending credit to potential debtors – medium and large-scale businesses.

Most likely, the credit crunch emerged from commercial banks following the outbreak of the financial crisis. A heavy reduction in outstanding credit took place in 1999. The credit dropped by 49% from Rp. 545.5 trillion in 1998 to Rp. 277.3 trillion in 1999. Since then, commercial banks have allocated small portions of their earning assets to loan portfolios (supply side) due to the reluctance of bank managers to take additional risks because of the low absorption of the real sector (demand side). In contrast, BPRs experienced a smaller reduction of outstanding loans of only 13% in 1998, one year earlier than commercial banks did.

Table 3-3: Loan to deposit ratio of commercial banks and BPRs as per December 1997-2003

No.	Bank Type	1997	1998	1999	2000	2001	2002	2003
A	**Commercial Bank**							
1	Indonesia	125%	87%	45%	46%	45%	49%	54%
2	Central Java	122%	72%	39%	51%	57%	62%	63%
B	**BPR**							
1	Indonesia	143%	133%	142%	137%	117%	112%	103%
2	Central Java	161%	135%	123%	116%	113%	107%	98%

As per December 2003 (Table 3-3), commercial banks remain in a position of under-lending, in which the LDR figures are 54% (national level) and 63% (Central Java). At the same time, BPRs can perform better in their intermediary function when their LDRs reach an ideal level nationally (103%) and in Central Java (98%). By seeing these conditions, some conclusions can be drawn:

1. Commercial banks at the national level as well as in Central Java have not yet recovered their intermediary function, like before the monetary crisis in 1998. A commercial bank is still in an under lending position. In 2003, commercial banks in Central Java were generally capable of running intermediation much better than national commercial banks.

2. Both at the national and Central Java levels, BPRs can execute the intermediary functions much better in the aftermath of the monetary crisis. In recent years (2001-2003) the LDR of BPR was nearly ideal, at the national level as well as in Central Java.

The difference in ability of these two bank categories in executing the intermediary function may be because of these factors:

1. BPR's reputation is improving over time with deposit holders, so that the deposit growth rate is increasing faster than the loan growth rate. The BPR category shows an increasing safety or lowering risk of BPR day by day. Financially well-off and moderately stable BPRs are eligible to join the deposit insurance scheme.

In addition, the proportion of bankrupt BPRs was lower than the proportion of bankrupt commercial banks during the crisis.

2. Commercial banks have more investment alternatives in the earning assets portfolio. The earning assets portfolio can consist of money market instruments, especially Bank Indonesia certificates, inter-bank time deposits, and long term instruments, especially state-bonds.

As a consequence, the low LDR of commercial banks led to their highest proportion of revenue mix coming from non credit operations. For example, Bank Danamon, one of the ten biggest commercial banks, generates low shares of income from loans (interest revenue) i.e., 18% of its total revenue (Rp. 6.95 trillion) as of the end of 2002. Thus, the earning asset components are not yet dominated by credit but by bank investments in securities, inter-bank deposit placements, government bonds, and equity participation. Bank Indonesia as the central bank views this condition as a barrier for banks in the transmission of the monetary policy.

A study about the intermediary function of commercial banks in Central Java (Sunarto and Wijayanto, 2004) reveals that one of the factors why the LDR is low is because the ability to absorb the real sector (debtors) is still low. Commercial banks optimistically and aggressively offer credit; however, the realization is below the target. This finding is consistent with the phenomenon of un-disbursed loans found in other areas as reported by Bank Indonesia (2004). In Central Java, there are about 2,291 office networks of commercial banks, which have their head offices mainly in Jakarta. Only two commercial banks have their head offices in Semarang, Central Java Regional Development Bank (Bank Bank Pembangunan Daerah Jawa Tengah, abbreviated as BPD – Jateng) and Bank Purba Danarta (PD). The latter two commercial banks can increase credit quality by decreasing the NPL below the upper limit established by Bank Indonesia, which is 5%. Per December 2003, the Regional Dev Bank reached an NPL of about 2% and an LDR of nearly 60%. Purba Danarta bank could reach an NPL of 2.2% and an LDR of nearly 30%.

As explained before, BPRs enjoy their main function as intermediary institutions better than commercial banks. According to Bank Indonesia statistics in Semarang, in 1993 the LDR of BPR in Central Java reached 157%. In the crisis time the LDR of BPR accounted for 110 % and was relatively constant until the fourth quarter of 2002, suggesting that total credit keeps on surpassing the deposit amount. At the national level, the LDR didn't differ very much. Per March 2002, the LDR of BPR reached 112.5%. The improvement in the aftermath of financial crisis is shown by the decreasing of NPL. For BPRs, the NPL declined from 16% (Dec 2000) to 11% (March 2002). Meanwhile, the NPL of BPR in Central Java in the 4th quarter of 2002 lowered to 8.9%.

The total credit of BPR in Central Java in the 4th quarter of 2002 was Rp. 1,53 trillion or about 29% of the total credit of BPR in Indonesia. The aggregate growth between loans and deposits was relatively at the same speed from December 2000 to March 2002. It is a signal that BPRs are in a position of contestable race in the financial intermediary market as opposed to commercial banks. The phenomenon can also reflect how well and skillful their ALMA (asset and liability management) is – in such a way that interactions between fund mobilization and credit granting are scrutinized closely by BPR's management team. Ironically, some policy makers remain pessimistic about the actual high performance of BPRs, and therefore they underestimate the role of BPRs in general and some microfinance institutions like *Swamitra* cooperatives.

Although the LDR is high, generally BPRs have other earning assets. Aside from loans, the earning assets of some BPRs may consist of inter-bank assets (time or savings deposits in either commercial banks or BPR counterparts). To prevent liquidity, some BPRs keep a certain level of current accounts (demand deposit) in commercial banks nearby.

Table 3-4: Total overall deposits of BPRs to commercial banks and total outstanding credit of commercial banks to BPRs as per December 31, 2000- 2004

1 = billion Rp.

Year	BPR deposits to commercial banks				OSC to BPR	Loan to cooperatives	Surplus
	Total deposits	Demand	Savings	Time			
2000	292	72	70	150	101	4,966	191
2001	685	175	125	385	130	5,107	555
2002	1,017	340	167	510	194	6,702	823
2003	1,507	555	332	620	353	8,221	1,154
2004	1,475	518	297	660	768	8,786	707

Source: Economic and financial statistics, Bank Indonesia, January 2005

According to the President Director BPR Surya Yudha, a high ranking BPR in Central Java (2004), overall BPRs have more money deposited in commercial banks than they receive in terms of loans from commercial banks. This idea triggered the BPR association to propose the creation of a coordinating institution to potentially manage a pool of BPR funds. This statement was corroborated by facts as shown in Table 3-4. As shown in Table 3-4, in 2003 the overall BPR surplus of funds was Rp.1.5 trillion rupiah, which implies there was not a real fund shortage of overall BPRs. This phenomenon is reflected in precautionary actions taken by some BPRs (a) that place their funds in commercial banks for liquidity needs, (b) for transaction mediums i.e., collection of loan repayments and transfer of funds among BPRs, and (c) for cutting losses of unused funds by minimizing on hand cash and placing it into short term time deposits. More importantly, this phenomenon is relevant to the ongoing proposal about Apex bank, and the real value of the linkage program is still in question.

3.4 The Business Climate of Microfinance

This section presents a synoptic review of the business climate of the microfinance industry that will put more emphasizes on scanning the microfinance market and regulations affecting entry-exit barriers, players in the market, and cooperation and competition among them. An analysis of the players in the market and cooperation and competition among them will be presented on a specific region, Central Java, in section 3.5.

Surprisingly, the gap between supply and demand of funds for SMEs financing remains a hot topic of discussion among interest groups, namely politicians, researchers-academics, business practitioners, and policy makers. The Technical Assistance Asian Development Bank (TA-ADB) revealed that only 21% of SMEs received bank loans[1]. TA-ADB raised a question regarding how come many SMEs cannot get bank loans as needed. This classic question looks strongly tempting to those interest groups in this area of concern due to the fact there are enormous players in the microfinance market. Since the onset of the economic crisis, this small segment of the SME loan market has been served by all sizes and various types of financial institutions: commercial banks, BPRs, cooperatives, and non-depository institutions such as multi finance companies, pawnshops, regional venture capitals, and even state-owned enterprises (in the real business sector) by providing direct soft loans and commercial loans to SMEs. This question remains a big puzzle to parties who are concerned about the SME credit market. From the supply side, an abundant source of funds should be available but are not easily accessible. The above-mentioned question is still relevant to answer.

Unfortunately, the above interest groups have no unified understanding and vision toward SME loan policies and implementation. For example, various definitions of SMEs and small business loans actually include consumers and micro loans. On January 4^{th}, 2001, Bank Indonesia revised the definition of a small-scale business (enterprise) and corresponding credit extension or small business loans (KUK[2]), essentially raising the credit ceiling from Rp. 350 million to Rp. 500 million. The TA-ADB identified 39% or 3 million out of 7.7 million KUK accounts were BRI micro loans (ADB, 2001). The BRI through its BRI units serves micro entrepreneurs as well, implying that the discussion on SME loans is inclusive of micro enterprise loans. For this reason, the size of the micro, small and medium business loan market is not easily measured accurately. From the field observation, it reveals that the delicate problem about supply and demand of credit lacks coordination among the policy makers, especially in the case of credit programs that carry subsidies that distort the commercial loan in microfinance market .

3.4.1 Competition among Players in Micro Credit Markets

The scope and players in the microfinance market are not easy to measure. BPR managers see that the players are not confined to all types of MFIs those presented in Table 3-5 but also the Regional Development Bank (BPD) and some other commercial banks such as Bank Danamon, Bank Niaga, BCA, etc., which enter the micro credit market. As an example, the total assets or credit of all of the 380 BPRs in Central Java is only 50% in asset or credit of BPD as per December 31, 2002. It means that the market leader of microfinance market are commercial banks, not only BRI but also some other commercial banks.

The eruption of the economic crisis triggered most commercial banks to start to discover the potential retail market of small-scale business loans as profitable segments at a lower rate of default. The underlying reasons to serve this market are (a) the past devastating experience of corporate loans, which had led to huge losses in loan defaults and (b) Bank Indonesia's active promotion of SMEs and micro enterprises by encouraging commercial banks to expand their lending to SMEs. Creative and innovative commercial banks took this opportunity. Among others, in 1997 Bank Bukopin set up a business partnership arrangement with various selected cooperatives and microfinance institutions under the common name *Swamitra*[3]. The word *Swamitra* is adapted from an ancient Javanese word meaning self-partnership that denotes a partnership free of coercion, built on the basis of self-determination and mutually beneficial relationships. This kind of strategic alliance is seen as an important case of implementing the "bank relationship and relationship marketing" concept. Although Bank Bukopin and its corresponding cooperatives may not be aware of this term or call it an outcome of "bank relationships and relationship marketing", they are actually practicing a bank-client relationship concept.

Table 3-5: Profiles of both formal and non formal microfinance institutions in Indonesia

No.	Type of MFIs	Number	Deposits		Loans		
		Units	Rp. bn	Accounts (millions)	Rp. bn	Accounts (millions)	Average (Rp. million)
A	**BANK**						
1	BRI units (Apr 02)	3,916	23,460	28.20	12,000	3.00	4.00
2	BPR (Mar 03)	2,133	6,629	5.10	7,088	1.90	3.73
3	BKD (Mar 02)	5,345	25	0.54	185	0.45	0.41
	Sub-total	**11,393**	**30,054**	**33.30**	**19,270**	**5.40**	**3.57**
B	**Non-bank**						
B.1	**Formal**						
1	SCC (Apr-00)	1,097	85	n.a..	531	0.66	0.81
2	UCC (Apr-00)	35,218	1,157	n.a.	3,629	N.a.	0.36
3	LDKP (June-00)	2,272	334	n.a.	358	1.30	0.28
4	Pawnshops (Dec02)	739	1,844	n.a.	5,970	15.70	0.12
	Sub-total	**39,326**	**3,420**	**n.a.**	**10,488**	**17.66**	**0.36**
B.2	**Non-formal**						
1	BMT (Des-01)	3,038	209	n.a.	157	1.20	0.13
2	BK3D (Jun-00)	1,105	118	n.a.	n.a.	0.25	n.a.
	Sub-total	**4,143**	**327**	**n.a.**	**157**		**0.11**
	TOTAL	**54,563**	**31,597**	**n.a.**	**26,388**	**35.96**	**0.73**

Source: Bank Indonesia Jakarta, Directorate of BPR supervisions, Abdul Salam and pawnshops annual reports, 2003

Note: SCC: Savings-credit cooperatives; UCC= Unit Credit Cooperatives ; n.a. = not available
BMT= Baitul Maal wat Tanwil, micro-finance institutions operating under the sharia system
LDKP, BK3D are village level microfinance institutions, which are owned mostly by local village governments. Pawnshops are non-depository microfinance institutions.

This bank relationship can be inferred from the field visits and discussions with the heads of the Swamitra division in Bank Bukopin (Feryd, 2003[3]), who are responsible for 11 *Swamitras* in Central Java and nine *Swamitra* directors are located in Ambarawa, Ungaran, Semarang, and Purwodadi. The research revealed that the

[3] Discussions took place during a field visit with Mr. Feryd in May, 2003.

selected cooperatives (trader and agro-business cooperatives), as partners of Bank Bukopin, were long standing high quality bank clientele. There are about 50,000 cooperatives in Indonesia; but in 2000, only 200 of them were selected to be Bank Bukopin partners to establish a *Swamitra.* The number of *Swamitra* increases from year to year. Bank Bukopin deposited a significant amount of funds into Swamitra without any physical collateral. As a strategic choice to manage the risk of extended funds, Bukopin controls *Swamitra* by selecting and training its personnel and investing the advanced/latest on-line technology, enabling the assigned bank officers to monitor *Swamitra* debtors on a timely basis and facilitate inter group financial transactions among *Swamitra* outlets all over Indonesia. The development of *Swamitra* as a breakthrough concept from Bank Bukopin in micro-finance institutions in Indonesia to some extent will challenge the continuation of the BRI Unit. Their advancement in technology and professional “bank” management is impressive.

Swamitra as a non-bank financial institution should be categorized as a savings-credit cooperative under the supervision of the Department of Cooperatives and Small Scale Businesses. In general, cooperatives have special political privileges in Indonesia in gaining access to any soft loans for social safety net programs.

Per September 2002, Bank Danamon had Rp. 54.3 trillion in total assets. Starting from June 30, 2000, the government had 99.35% of stocks in the Rp. 28.87 trillion recapitalization program and merger with eight banks In 2002/2003 Bank Danamon penetrated microfinance market by establishing UKM Center division. Then it became more aggressive in 2004 by opening outlets - a savings and loan unit named Danamon Simpan Pinjam (DSP). By the end of 2004, Danamon bank announced the grand opening of 12 DSP units in Central Java and the special governmental district of Yogyakarta. Out of 524 overall DSP units spread over three of the most popular islands: Sumatra 81 units, Java 429 units, and Bali 14 units, it demonstrated that Central Java province is in the top ranked position with 149 DSP units and East Java hold the second ranked position with 127 DSP units.

In the middle of 2004, the BPR Indonesia association (Perbarindo) declared its objection of unfair treatment between BPR and commercial bank to Bank Indonesia through a formal letter. The reasons were that; (a) Danamon Bank can open DSPs easily while BPR faces some restriction in opening branches, (b) Bank Danamon hijacks the BPR employee, (c) indirectly some of the clients switch to DSP, because it is close relationship to hijacked BPR employee, and (d) DSP offers more attractive credit schemes. The chairman of Perbarindo claimed that these Danamon actions would deteriorate the microfinance market

Miranda Gultom, Deputy Governor of Bank Indonesia, believes that the potential of the micro credit market is still big, so BPR does not need to be concerned. Burhanidin Abdulah, the Governor of Bank Indonesia, sees that there is a competition problem between commercial banks and BPR. Commercial banks enter the micro credit segment and BPR enters the credit market of commercial banks. The DSP manager agrees with Miranda Gultom's statement[4]. All of the parties in dispute base their claims on the perception or inference and experience from their own point of view. So far, no action is being taken to measure competition in order to solve the problem. An intermediacy study of 104 commercial bank offices in Central Java (Sunarto & Wijayanto, 2004) shows that commercial banks tend to broaden the top and bottom ranges of loan principal. By Broadening the loan range of loan principal mean that commercial banks enlarge their credit segment that overlap to the BPR credit class.

The next players in the microfinance market are the BPRs licensed by Bank Indonesia, the only depository institution under the direct supervision and guidance of Bank Indonesia. Bank Indonesia pays more attention to the MFIs in building business climates through prudential regulations and supervisory roles. However, Bank Indonesia cannot control all types of MFIs, because some of them are beyond its responsibility. Only type A MFIs (Table 3-5), namely BRI units and the licensed BPRs are under their supervision. BKDs (non-licensed BPRs) are controlled indirectly by Bank Indonesia, since its surveillance authority is delegated to Central Java Regional Development Banks. These type A banks occupy bigger market shares in the microfinance market, accounting for at most 87.8% in fund sources (deposits) and 59.6% in loans/financing.

There is only one kind of state-owned pawnshop operating in urban areas all over Indonesia involved in a specific segment of the microfinance market. Most loans are extended to middle and lower income clients with livelihoods in manufacturing, fisheries, agriculture, commerce/traders, or common households. The pawnshops have special privileges in terms of collateral i.e., by law, they are allowed to use pledge collateral where the pawnshops keep the physical collateral in their warehouses, while customers are obliged to pay a predetermined fee for keeping the collateralized goods.

[4] Adapted from a local newspaper, Suara Merdeka, in a polemic debate according the commercial penetration into the BPR market in the middle of 2004

As a single institution, BRI units serve 2.8 million clients, while pawnshops serve a much larger clientele of 15.7 million.

Fast growing kinds of microfinance institutions are those gaining support politically and socio-religiously accepted as a new approach to serve the grass root segment, whose majority are Moslems, by implementing a sharia system called Baitul Maal wat Tamwil (BMT). Beyond the reach of Bank Indonesia, these BMTs have grown rapidly in the aftermath of the banking crisis, reaching more than 3,000 units.

The rest of the players in the microfinance market are those categorized as informal MFIs that are not recorded statistically in an accurate and consistent way. Among others, they consist of self-help groups such as ROSCA, moneylenders, etc.

The main actors in the microfinance market generally include BRI Units and BPR. In Central Java the actors are shown in the following table:

Table 3-6: Some data of main micro financial institutions in Central Java per December 31, 2002

No.	Type	Units Offices	Units Prop.	Funds (Rp. bn.)	Credit (Rp. bn.)	LDR (%)
1	BRI Unit	789	52%	1.611,6	1.070,5	66,4%
2	BPR BKK & BKK					
	BPR BKK	350	23%	533,4	595,2	111,6%
	BKK	160	10%	120,6	127,8	105,9%
3	BPR non BKK	228	15%	940,3	983,2	104,4%
Total		1.527	100%	3.205,9	2.776,7	86,6%

Sources: (1) BRI 2004, (2) Supervisory board of BPR BKK Central Java 2003, (3) statistical office of Semarang 2005 and (4) Bank Indonesia Semarang, June 2004.

Table 3-6 shows that there are 789 BRI Units or 52% total units, 510 units of PD BPR BKK & BKKs or 33% of total units; and BPR non BKK accounted for 228 or 15% of total unit. By considering that 789 BRI units, regional company which consist of 28 PD BPs ("market bank") 350 PD BPR BKKs, and 160 BKKs are all owned by the government, it is clear that the microfinance market in Central Java is led by a government owned MFIs. Even some BPRs- non BKKs are owned by a state-owned bank: e.g. BPR *Swadarma* is owned by BNI-46. BRI village units, as microfinance market leaders, have a strong competitive advantage in both the funding and loan side. They are able to mobilize larger funds than they need for credit extensions. Furthermore, the BRI village units compete in pricing, which is discounted prices on credit to selected high-grade debtors. Debtors who are able to make payments in a timely fashion will get discounted loan prices, namely incentives for timely repayments (from KUPEDES loans). While the other BPRs compete through non monetary means – services under the close bank-client relationships, because they cannot beat the prices in competing with BRI village units. Only 9.1% of BRI unit offices are in Central Java, while on Java island they account for 61.7%.

The competition in the microfinance market in Central Java is getting harder now. The players in the market are not only the 584 BPRs under the control of Bank Indonesia Semarang, but also other microfinance institutions under the Department of Cooperatives and SMEs (*Departemen Koperasi dan Usaha Kecil Menengah*) i.e. 529 BMTs, 759 savings-credit cooperatives (*Koperasi Simpan Pinjam*) including 25 Swamitras that applied for advanced technological information and are supported by Bank Bukopin. BRI, as the market leader in the microfinance market, has a network of 781 village units. Additionally, there are some commercial banks taking part in it through BPRs and multi-finance companies. Another way is to have direct divisions in banks. For example, Bank Danamon has 7 centers of small-medium scale business activities and cooperatives (UKMK-Center); one of them is located in Central Java. Another example is BNI-46 in Central Java that opened micro-service units in early 2003.

As seen in Table 3-6, the intermediacy function of BPR BKK & BKK and BPR non BKK was close to an ideal position which is indicated their LDR between 80% to 110 %.

Table 3-7: Some Central Java BPR indicators based on office areas of Bank Indonesia, December 31, 2004

No.	BI Office	Number	Assets (Rp. bil)	Funds (Rp. bil)	Loans (Rp. bil)	LDR (%)
1	Semarang	368	2.010	1.501	1.414	94,2
2	Solo	135	885	603	645	106,9
3	Purwokerto	81	438	316	328	103,8
	Total	584	3.333	2.420	2.387	98,6

Source: Economic and financial investigation of BI Semarang, 2004

The intermediacy function of the BRI Unit was below the ideal with the LDR less than 70%. The BRI Unit, which has high reputation in the international microfinance community, was actually in a position of under lending. It means that surplus of fund from BRI Units is transferred to the BRI branches in cities. As per December 31, BRI units in Central Java had a surplus of funds of Rp. 541,1 billion. On the other side, BPR BKK & BKK lacked Rp. 69 billion in funds and BPR non BKK lacked Rp. 42,8 billion in funds. BPR could cover their lack of funds through (a) owner equity, (b) commercial bank lending: linkage program, (c) credit lending programs from PT. Permodalan Nasional Madani, and (d) other institutions: Mitra Daya Jimbaran, Oikocredit, PT. UKABIMA, Pension Fund institutions, etc.

Per September 2003, most BPRs became members of the BPR association, including 75% at the national level and 65,5% (379 from 582 BPRs) in Central Java. BPRs in Central Java are divided into three office areas of Bank Indonesia, which can be seen in Table 3-7. The office area of Bank Indonesia in Semarang covers 63% (368 BPRs) from the total number of BPRs in Central Java. These BPRs extend credit accounted for Rp 1,4 trillion or 59,2% total credit and collect deposit Rp. 1,5 trillion or 62,0% total funds.

3.4.2 Linkage Program: A Cooperation Scheme between Commercial Banks and BPR

Per 4th quarter of 2002, the fund mobilization from the society, which did not pass on as credits in commercial banks, reached Rp. 17.5 trillion for Central Java and Rp. 427.2 trillion at the national level. On the other hand, the lack of funds experienced by BPR was only Rp. 156 million in Central Java and Rp. 584 million in Indonesia (March 2002). There are many reasons why commercial banks had difficulties in giving out funds to BPR, but it had very little to do with the problem of information asymmetry in the financial market, which this study will focus.

In 2002, a research team from Bank Indonesia Semarang in cooperation with three prominent universities in Central Java, the Faculty of Economics of Satya Wacana Christian University (Salatiga), Sebelas Maret University (Solo), and Sudirman University (Purwokerto) tried to reveal the synergy between commercial banks and BPR in allocating their funds to SMEs in Central Java. The proposition held was that commercial banks could collect deposits from the many levels in the society easier but had difficulties in extending credit from their funds to SMEs. In contrast, BPR had more abilities in disbursing credit to SMEs but difficulties in collecting funds. However, the research results didn't show any significant synergy between those two institutions.

Efforts to create this synergy between BPR and commercial banks can be traced back to the year of 1990. As per January 29, 1990, Bank Indonesia launched a package on Small-scale Business Loan (SBL) program from commercial banks. A mandatory to all commercial banks to allocate a minimum 20% credit portfolio to small scale businesses with a maximum of up to Rp. 200 million. The Indonesia Export-Import Bank initiated to sign memorandum of understanding with the National Association of BPRs on March 16, 1990. BPRs were treated as a small-scale business and eligible to access SBL. This event can be considered as starting point of a national wide cooperation between commercial bank and BPRs and ten years later, in 200s, this phenomenon is named by Bank Indonesia as “linkage program”.

Thus, substantially the efforts made by BI Semarang to push commercial banks and BPR to create synergic alliances are not new; it only puts stress on the importance.

Bank Danamon is one example of a bank that cooperated with the association of BPRs Indonesia (*Perbarindo*) in 2002. Specifically it made 7 Centers for Small-and Medium-Scale Businesses and Cooperatives (*UKM Centers*). One of the centers is located in the Bank Danamon regional office in Semarang. Though Bank Danamon allocated about Rp. 2 trillion KUK in 2002, BPR was only a small part of other debtors, especially big companies’ cooperatives (Koperasi Astra Graphia) – selling their products to small businesses in credit.

Bank Indonesia attempts to decrease the tense competition between commercial banks and BPR through a linkage program. A linkage program is based on the assumption that:

(1) A commercial bank has advantage in funding and in under lending position (low LDR),.
(2) Commercial banks cannot reach SMEs directly; however, they have a business plan to distribute credit to SMEs.
(3) BPRs lack funds.
(4) BPRs are able to directly reach SMEs.

Based on the assumptions mentioned above, Bank Indonesia has a cooperation scheme between commercial banks and BPR called a “linkage program” (Abdul Salam, Sept. 2003) with four types, and BPR has the role of a middleman (Table 3-8).

Table 3-8: Type of linkage program between commercial bank and BPR

Type	Those parties that bear credit risks
1. BPR as an executing bank	BPR
2. Joint financing	BPR & commercial banks
3. Channeling	Commercial banks
4. Buying assets	Commercial banks

Source: Abdul Salam, 2003

At the national level, Bank Indonesia notes that per December 31, 2003, there were 28 commercial banks and one state-owned financial institution (PT. Permodalan Madani, PT PNM), which implemented a linkage program. 948 BPR units used the program.The average loan principal per BPR increased 52% from Rp. 494 billion (December 2002) to Rp. 751 billion (December 2003). Average OSC per BPR increased from 24% from Rp. 366 billion (December 2002) to Rp. 453 billion (December 2003). However, total BPRs decreased 8% from 1.029 BPRs (December 2002) to 948 BPRs (December 2003). As per December 31, 2003, accounted for 44.4% out of 2.134 BPRs in Indonesia and 27.1% (158 units) out of 582 BPRs in Central Java participated in a linkage program.

Table 3-9: Linkage programs of some commercial banks in Indonesia and Central Java December 31, 2003

No.	Name of Bank	Indonesia			Central Java		
		BPR	Principal	OSC	BPR	Principal	OSC
1	Bank Mandiri	212	147,053	82,638	33	24,768	9,230
2	Bank Central Asia	92	40,355	23,274	14	6,300	3,782
3	Bank Danamon	96	93,556	63,261	24	24,462	20,668
4	Bank Niaga	78	128,364	80,478	5	2,750	1,474
5	Bank Internasional Indonesia	87	128,650	92,365	27	14,800	12,320
6	Bank Muamalat Ind (Sharia)	23	19,365	10,527	0	0	0
7	BPD Central Java	46	2,830	314	46	2,830	314
8	Bank Bukopin	20	9,891	9,664	0	0	0
TOTAL		654	570,064	362,521	149	75,910	47,788
			100%	64%		100%	63%

Source: KKMB, Bank Indonesia, July 2004

Note: The name of banks are chosen only Commercial Bank those are serving relatively significant number in Indoneesia level.

Table 3-9 shows that Bank Mandiri had the biggest number of BPRs in Indonesia. It is reasonable since Bank Mandiri provided a micro credit program with low interest, about 4% lower than the prevailing market rate. Per December 31, 2003, in Central Java only 33 BPRs used credit from Bank Mandiri, smaller than the Regional Bank of Central Java (BPD) which provided credit for 46 BPRs.

Table 3-9 illustrates that Bank Bukopin, a conventional bank, and Bank Muamalat Indonesia, a sharia bank, ran linkage programs at the national level; however, it did not run them in Central Java. Nevertheless, Bukopin did engage in strategic alliances with a minimum of 25 Swamitra savings and loan unit cooperatives.

Though there was no public information regarding why Bank Muamalat did not join the linkage program with BPR Sharia in Central Java, actually they needed funds.

It is not easy to determine if the linkage program is able to reduce competition between BPR and commercial banks. It is also difficult to determine if the linkage program is able to create synergy. Commercial banks, which are part of the linkage program, except Bank Mandiri and PT PNM, provide credit with commercial interest rates. BPR, which has an increasingly good reputation, can accept funds from society in the form of time deposits with lower interest rates.

3.4.3 Wholesale Financial Institutions

Most BPRs rely on individual citizens for their source of funds, in the forms of time deposits and savings accounts. However, institutional sources of funds, such as Pension Fund institution, are also used by BPR as credit or deposit sources. As big fund owner institution, overall pension-fund institutions in Indonesia invest their fund accounted for about Rp. 50 trillion (2004), most of which were in commercial bank deposits. Only very small portion of their fund go to BPRs. Based on risk and return consideration, pension-fund institutions should find out that deposit in BPR as a prospective investment opportunity. Actually, commercial banks and BPR were in the same risk class because by law, both of them are participating in Deposit Insurance Agency of which bank deposits are guaranteed. On average, BPR offers deposit interest rates of about 4% up to 5% higher than the commercial bank interest rate. The investment theory says that a given two investment opportunities (assets) in the same class of risk, an investor should invest her/his fund in an asset that promise higher return. By referring this principle, there is no reason for investors, such as pension-fund institutions, to neglect the deposit in BPR as one alternative option in portfolio selection process of investment. Most likely, these institutions have hidden reason that see BPRs' deposit carry higher perceived risk so that the higher deposit interest rate cannot compensate the risk. In other words, reputation of BPRs are still questionable to some of fund owners. If this is the case, the information asymmetric problem between BPR and fund owner has not yet been solved.

On another side, the BPR association (Perbarindo) has been building long term relationship with some " Wholesale Financial Institutions" (Table 3-14) as alternative sources of funds for BPRs. The relationship between the wholesale and some BPRs member of Perbarindo has reduced asymmetric information among them that make easier to the wholesale in placing fund to some selected BPRs.

Table 3-10: The wholesale financial institutions channeling funds to BPR

No.	Establishment	Wholesale Financial Institution	Ownership
1	1975	Oikocredit, EDCS Ecumenical Development Co-operative Society Head office: Amersfoort, The Netherlands http://www.oikocredit.org	Private
2	1996	PT. Usaha Karya Bina Mandiri (UKABIMA), Self Reliance Corporation Ltd. http://www.ukabima.com	Private
3	1997	PT. Mitra Dana Jimbaran, Jakarta http://www.mdjimbaran.com	Private
4	1998	PT. Permodalan Nasional Madani, Jakarta http://www.pnm.co.id	State

Sources: From their websites.

The chance to acquire funds from commercial banks is not as expected. BPR, however, still has opportunities from other institutions such as:

(1) PT. Permodalan Nasional Madani (PNM) in the form of working capital loans (*Kredit Modal Kerja,KMK*) for BPR, and micro credit projects (*Proyek Kredit Mikro, KMK*). PNM took over the credit for BPR from Bank Indonesia, which is no longer allowed to allocate credit after UU No. 23/1999 was passed on May 17, 1999. This became effective commencing on November 16, 1999,

(2) BPR can also acquire funds from PT. Mitra Dana Jimbaran (MDJ), whose funds come from 14 national leading groups of businessmen. They gather perpetual funds (endowment funds) and put them in commercial banks as deposits. The interest income from the bank deposit is allocated into two parts. First portion, around 15% to 20% interest income for business operation of MDJ and sponsorship donation. Second proportion of 80% to 85% of interest income is extended to the eligible BPRs to be loaned to SMEs. PT. MDJ works together with Perbarindo and then places funds in saving deposits for the BPR selected by MDJ. The BPR, as the executing bank, bears the risks of default from the credit to their clientele;

(3) PT. Usaha Karya Bina Mandiri (UKBIMA), a non-bank financial institution that has distributed funds to about 40 BPRs, mostly in Java and Bali. UKABIMA has a direct agreement with BPRs. Although the interest charged is a bit higher than

the interest of deposits, BPRs are willing to accept this since UKABIMA gives human resource development services without any extra charge;

(4) Oikocredit, which has its head office in Amersfoort, Netherlands has several branches in Indonesia which also offer credit to BPR, such as BPR Intidaya Masyarakat, BPR Bhakti Daya Ekonomi, BPR Guna Daya. Other BPRs are also aware of this offer, but they cannot conform with the requirements, especially the collateral, commercial interest rate and that the the approvedcredi must be taken all at once.

3.4.4 The Co-Existence of Subsidized and Commercial Loans

Indonesia, as an experimental laboratory of developing microfinance institutions (Gonzalez – Vega/Chaves, 1992; Steinwand, 2001), should go on. Based on Presidential decree No. 124/2001, September 7, 2004 government of Indonesia launched a Non-Collateral Proper Micro Business Credit (KUMLTA, *Kredit Usaha Mikro Layak Tanpa Agunan*). It was a turning point of credit policy from subsidized to market-based credit mechanisms. Some preconditions which motivate the policy are:

(1) Through a business plan, Commercial Bank supplied Rp. 43 trillion in credit to UMKM until the middle of 2004.Only Rp. 5 trillion was disbursed and Rp.38 trillion was not used.
(2) With the presidential banking principle, it means credit is allocated with pledge collateral.
(3) SMEs need credit, but they do not have collateral.
(4) Bad credit always exists; however, it is assumed to be less than 10%.

Based on the cases, micro and small credit experiments began with the following mechanisms:

1. The government, through the BUMN (State Enterprise) ministry, supplies cash collateral Rp. 200 billion Collateral is enough to cover the risk of bad credit accounted for 10% of the planned total credit that is 2 trillion to SMEs
2. Eligible SMEs are those which have run their businesses for one year or more, have track records, and are able to provide business plans. The business prospect is also part of the collateral.
3. First round of KUMLTA will start as follow. State-owned banks that receive cash collateral provided by the Ministry of Finance are Bank Mandiri (Rp. 75 billion), Bank Tabungan Negara (Rp. 10 billion), BNI (Rp. 30 billion), BRI (Rp. 30 billion), PNM (Rp. 25 billion), and pawn shops (Rp. 25 billion). The Bank Mandiri is appointed as coordinating bank.

These banks independently determine the rules and regulations of commercial loans for SMEs. It is important to remember that commercial loans still work together with subsidized loans under various labels (names). State-owned enterprises are still running three partnership programs in community development that are:

(1) State enterprises have been supplying the subsidized loans to SMEs. Antakusuma, Assistant of State Ministry Deputy-Owned Enterprises (2004) declared that they had dispersed subsidized loans in the amount of Rp. 3.4 trillion for 345,000 SMEs.
(2) State enterprises distribute funds through the local government. The local government acts as an executing agent.
(3) State enterprises act as commercial credit guarantees through the KUMLTA.

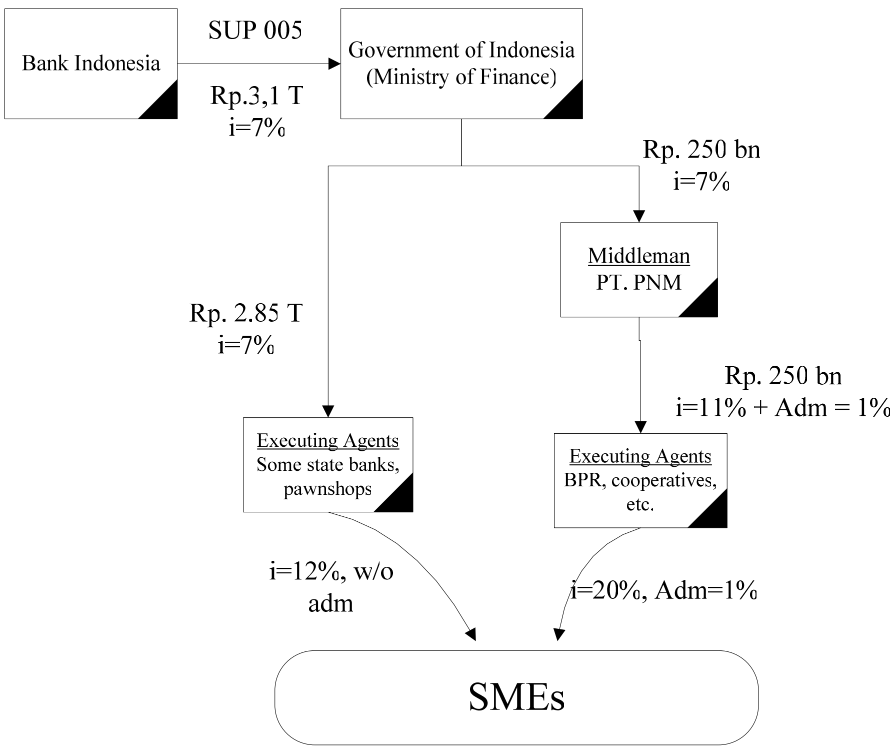
Subsidized credit to SMEs has been practiced since the 1970s. The credit programs are called small investment credit (*Kredit Investasi Kecil,* KIK) and permanent working capital credit (*Kredit Modal Kerja Permanen,KMK)*.

Fist of all, the Presidential Decree 90/1995, updated Presidential Decree 92/1996 assigned private-owned and state-owned corporations to allocate funds for poverty alleviation taken from 2%-5% of their net profits. Some private business groups established Dabanas Foundation and Mitra Dana Jimbaran Ltd. Co., in Jakarta accordingly to implement this program and set up cooperation with BPRs all over Indonesia. Meanwhile, instead of using BPRs, state-owned corporations prefer direct lending (or in some cases through cooperatives) to SMEs in the vicinity of their offices. Beyond the main objective to alleviate poverty, the strategies adopted by state-owned companies can indirectly gain political advantages as being "good neighbors" to surrounding SMEs. In the microfinance market there are two opposed parties, i.e. those in favor of market-based interest rates: Bank Indonesia and BPR administrators regardless of the category are against those in favor of subsidized loans: some legislative members / DPR, the governor of Central Java[4], the Department of Cooperatives and SMEs (*Dinas Koperasi dan UKM*), as well as a number of NGOs and socio-economic researchers in Central Java. It is not surprising that every regional government allocates funds as soft loans distributed through NGOs, cooperatives, BPRs, BMTs, etc. along with the local state-owned enterprises: PLN, TELKOM, PELINDO, etc. The funds are at a low 6% interest rate of credit. Meanwhile, BPR provides credit with an interest rate of 30% per annum. For example, the Telkom Central Java and Yogyakarta disbursed revolving soft loans at 6% p.a., reaching a total of Rp. 1.5 billion to 170 SMEs in mid December 2002, while the Indonesia Harbor Co., a state-owned company, Semarang Branch extended soft loans at a 6% p.a., amounting to Rp. 7.8 billion covering 81 cooperatives and 516 small scale businesses in early January 2003.

This kind of practice is ruining market based or commercial lending. Both Bank Indonesia and most MFIs are against this practice, but it still continues. Subsidized loan proponents usually come from those who are in favor of the socialism approach of poverty alleviation.

The microfinance market is a complex market. Many of commercial banks and BPRs may distribute both commercial loan at prevailing market interest rate and subsidized loan. On June 2, 2004, the Central Java Provincial Government declared that subsidized credit came from government bonds (SUP 005). The total funds available are Rp. 3.1 trillion at national level. BPRs in Central Java can apply this soft loan through PT PNM Semarang branch that authorized to manage the SUP 005 Rp. 205 billion.

Figure 3-4: The flow of state bond (SUP-005) funds to SMEs through some alternative financial intermediary institutions



Notation: i = interest rate (% p.a.), Adm =administrative cost, w/o= without.

The government of Indonesia owed to Bank Indonesia, with an interest rate of 7% p.a. (discount rate Bank Indonesia certificate). The PNM got a 4% margin relatively without risk, because PNM only gives credit to healthy BPRs (class A). In addition to cost of fund of 11% (7%+4%), BPRs were allowed to set interest rate up to 20% p.a..

At the same time, BPR offered credit with a market interest of about 24% up to 30% p.a. Also, at the same time, BPR had to compete with commercial executing banks, which directly got the funds without a mediator. The commercial banks were BRI (Rp. 500 billion), BNI (Rp. 350 billion), BTN (Rp. 250 billion), Bank Mandiri (Rp. 250 billion), Bank Bukopin (Rp. 300 billion), pawn shops (Rp. 200 billion), and Regional Development Bank (Rp. 750 billion). With the same source fund i.e. SUP 005, these banks were able to set interest rate of loan at least 4 % lower than that interest rate of loan extended by BPRs to the same target market of BPR . Eventually, the two river mouths that provide two different loan interest rates, low ("subsidized") and high ("market rate"), enter the same segment of SMEs, as depicted in Figure 3-4.

As a result, the commercial banks fixed the credit interest rate at about 14% up to 17%. Pawn shops set the maximum credit interest rate at 19% p.a. In sum, the same market segment was serviced by BPRs, other MFIs, and commercial banks with various interest rates.

3.4.5 The Entry – Exit in the Banking Industry

On October 28, 1988, a monetary and banking deregulation policy was put into effect opening the door extensively for investors who wanted to enter financial and banking industries. The lax regulations included: (a) a low minimum required paid up capital, (b) qualifications as director and board commissioner without prior banking experience, etc. The regulations were valid for commercial banks and BPR. Then the number of BPRs and commercial banks increased rapidly. A positive impact on the community was the bank service was more convenient, funds were mobilized. A negative impact which occurred in the 1990s was that credit was misused by some business groups of various private-owned banks.

The 1990s regulators, Bank Indonesia and Ministry of Finance started firming up non financial regulations that bank owners had to have good track records. New board of commissioner member and directors, at least 50% from the personnel have had prior banking experience. Gradually, the strict regulations or the entry barriers to banking industries were increasing. The minimum financial capital for a new BPR in 1998 was Rp. 50 million; then it increased to Rp. 500 million up to Rp. 2 billion beginning in 1999. Beginning in August 2004, it has increased from Rp. 1 billion to Rp. 5 billion. Finally, based on the banking architecture policy- the required minimum capital for a BPR will be Rp. 10 billion in the year 2010. In that year, the minimum requirement for a commercial bank will be Rp. 100 billion.

In the aftermath 1998 economic crisis there are no additional commercial banks. In the same period, BPRs were still growing -hence the net addition[5] of BPR is positive; meaning the number of BPRs entering the small banking industry is bigger than the ones exiting. The increasing number of BPRs only happened in BPR non-BKD, i.e. from 2,140 banks (1997) increased to be 2,427 banks (1999), or there were 287 new banks (a 12% increase). Meanwhile, BPR-BKD has been stagnant with 3,345 banks since 1998. The 117 BPRs that closed down from 1999-2002 were spread all over Indonesia with the biggest portion in West Java, East Java, and Bali. It didn't have much of a negative impact on BPRs overall, since people's savings and funds were guaranteed by the government's blanket guarantee scheme. Chronologically, the number of BPR closed was 98 BPR (1999), 38 BPR (2001), and 44 BPR (2002). There were no closure in 2000.

Table 3-11: The distribution of BPRs that were closed by monetary authority, Bank Indonesia, from 2001-2002

No.	Region of Bank Indonesia	BPR (Units)	**Deposits** (Rp. billion)
A	**JAVA**		
A.1.	**West Java & Jakarta**		
1	Jakarta, Bogor, Bekasi	32	18.415
2	Bandung	5	3.112
3	Cirebon	1	0.600
A.2.	**Central Java**		
4	Semarang	2	1.614
A.3.	**East Java**		
5	Surabaya	9	2.884
6	Jember	2	1.155
7	Malang	3	1.358
B	BALI		
8	Denpasar	23	48.634
C	**SUMATRA**		
9	Medan	4	5.121
D	**LESER ISLAND**		
10	Kupang	1	7.807
Total		**82**	**89.355**

Source: Bank Indonesia

[5] The difference between new (BPR) entrants and new (BPR) exits (closure, merger).

On Java Island, as shown in Table 3-11, the number of bank closures in Central Java was smaller than those in Jabotabek, West Java, and East Java. The highest percentage was in Jakarta and its neighboring areas (Jabotabek) i.e. 32 BPRs (39%).The bankruptcy of BPR actually did not only happen during the crisis period. At the end of 1992 (on September 25, 1992), Bank Indonesia shut down the operations of 23 BPRs of the Surya Sahabat group, which mostly operated in East Java (Bisnis Indonesia, December 2, 1992). The following deposit rush in one of the BPRs of the Balido group happened in 1993, then made the 12 BPRs in the group closed in 1995 (Infobank, October 6, 1995, pp. 42-43). This kind bandwagon or contagious effect on bank run of BPRs that lead their closure is most likely occur in the BPR group.

3.4.6 BPR Infrastructure and Local Dynamics

(a) Hope for Apex Bank

Hand in hand with the government, though not always in line, Bank Indonesia plays an important role in creating a business climate in the MFI market, although limited to type A MFIs (Table 3-5), by issuing and implementing several regulations covering (1) supervision systems, (2) prudential banking principles, (3) bank liquidity, and (4) government deposit guarantees. The supervision systems are implemented by on and off-site supervision with the assistance of public accountants. Unlike commercial banks, the off site supervision still faces constraints in data processing due to a lack of fast and accurate processing of huge financial reports from thousands of BPRs. In 2001, the early development of a BPR database was underway. The prudential banking principles comprise a wide range of regulations, including provisions of NPLs, fit and proper tests to improve management quality, micro credit projects[5], and small-scale business loan implementations. Bank Indonesia, by law, cannot provide liquidity assistance to BPRs regardless of any critical situation of cash-flow mismatch or in bank run condition as indicated by a rush of deposit withdrawals. For this reason, BPR associations (*Perbarindo*) at the national or regional level are preparing to establish a "pooled fund" institution, instead of solving the illiquidity problem individually. As a member of *Perbarindo*, BPRs experiencing illiquidity problems (cash flow mismatches) are eligible to receive emergency funds drawn from the pooled funds.

In the severe competition in the credit and funding market, BPR members of *Perbarindo* Central Java are likely to face cash-flow mismatch problems at any time.

The liquidity management problem cannot be handled individually. BPR doesn't have any reserve funds in Bank Indonesia, since there are no obligations to meet liquidity reserved requirement by Bank Indonesia just as is done by commercial banks. The desire to establish an institution handling this liquidity problem had occurred prior to the crisis. There was a private BPR association for Central Java and the special administrative district of Yogyakarta area named HIBPERTA[6]. On April 8, 1994, in "Kusuma Madya" Hotel in Bandungan, Ambarawa, the HIBPERTA decided to establish Manunggal Utama Cooperative. Three out of the four aims of the cooperative relevance to preventing cash flow mismatch were:

(1) to supply the financial work capital for credit liquidity for emergency needs,
(2) to provide loans for office stock supplies and computers, and
(3) to raise funds for soft loans from state enterprises and through other donors.

One of the cooperative board of directors was L. Arum Riyana, the head director of Utama PT. BPR Mekar Nugraha Klepu. Cooperative members were BPR representatives such as the one of the directors or commissioners of BPR The basic savings was Rp. 500.000,- and additional deposit on top of the Rp.500.000 which is obligatory savings was Rp. 25.000 - /month. Once a cooperative to collect funds was established but then closed down, since legally BPR is not allowed to put its funds into a business, in this case a cooperative. It did not dissolve, however, since in October 1999 the BPR association announced its intention to establish the Liquidity Fund Foundation. During the *Perbarindo* workshop in January 2003, it had been decided Perbarindo members that the administrator for the funds collected would be a financial sound (healthy) BPR Weleri Makmur, where each member put in 1% of their capital funds, and when they experienced illiquidity they could propose liquidity support of up to 100% of their paid up capital. A little support came from BPR member of Perbarindo that lead this foundation did not work as planned.

Finally, a new Apex Fund Institution (AFI) began in operation since its grand opening on December 23rd, 2005 for two provinces. Central Java and Bali provinces are pioneering in AFI implementation. At the start, only 70 BPRs (out of around 380 BPRs) in Central Java are committed to place Rp. 20 million perpetual deposit to the AFI. In the short run, its function will be a pooling of funds to assist BPR which face liquidity mismatch problem. In the long run, it will also perform as (a) a BPR's

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[6]At the present it is called Perbarindo, with open membership for all types and ownerships of BPR.

wholesale financing body, (b) a clearing house for BPRs payment system, etc. (BI, Jan 11, 2005). The BPR association expects that the AFI become an Apex Bank that can execute multitude functions.

(b) Loan and Deposit Insurance Institutions

Focus group discussions on MFIs revealed that the majority of MFIs do not have cooperation with any of available credit guarantee institutions, such as PT. Penjaminan Kredit Pengusaha Indonesia (PKPI), PT. Asuransi Kredit Indonesia (ASKRINDO), and Asuransi Ekspor Indonesia (ASEI) or (Indonesian Export Credit Insurance), Perum Sarana, PT. Perum Pengembangan Koperasi in extending loans to SMEs. They prefer using life and loss insurance to insure physical collateral.

Table 3-12: Credit insurance institutions in Indonesia that serve SMEs by year of establishment.

No.	Established	Institution name	Shareholder	Client
1	1971	PT. Asuransi Kredit Indonesia (Askrindo) http://www.askrindo.co.id	BI 55% MoF 45%	6 million SMEs (2004)
2	1971	Perum Sarana (Lembaga Jaminan Kredit Koperasi) http://www.perum-sarana.com	State	Cooperatives & SMEs (including BPR)
3	1983	PT. Asuransi Ekspor Indonesia (ASEI) http://www.asei.co.id	State	SMEs Credit and general insurance
4	1981	PT. Perum Pengembangan Koperasi	State	Cooperatives and commercial loans (since 1996)
5	1981	PT. Penjaminan Kredit Pengusaha Indonesia (PKPI)	n.a.	SMEs

Sources: Compiled from many written sources (newspapers, business magazines, and web sites)

Credit insurance institutions promote credit transactions which are not fully bankable, which means that the debtor cannot fulfill collateral but economically still feasible. The insurance institution offers a two-party agreement with the creditor, generally with a commercial bank. The insurance institution as guarantor and financial bank was the guarantee receiver and borrowers as the guaranteed. Perum Sarana had special product to Cooperative and SMEs, including BPR as debtor of commercial bank. Credit insurance is different from life assurance, which in life assurance, personally the risk is guaranteed.

Finally, the Deposit Insurance Agency was inaugurated on September 22, 2005 to maintain banking system stability. Since then, the change from blanket to limited guarantee to bank deposits get started.. Though the blanket guarantee was established in early 1998 to restore public confidence following heavy bank runs in response to the closure of 16 commercial banks on Nov. 1, 1997, BPRs were not included in the guarantee scheme until the end of 1998. The new deposit insurance scheme is mandatory for all banks – commercial bank and BPR. The Deposit Insurance Agency will initially charge a rate of 0,1 percent uniform premium of a bank's third-party funds (deposits). The scope and amount of deposits covered by government blanket guarantee will be gradually reduced up to a maximum of Rp. 100 million client/bank starting from March 22, 2007. Compared with some other countries (Table 3-13) in Asia which have deposit guarantees, the value of maximum guarantee in Indonesia is relatively high, that is about US $10,000.

Table 3-13: Comparisons between some deposit insurance institutions of a few selected countries

No.	State	Established	Premium (%)	Coverage (US$)	GDP/Capita (US $)	Ratio
1	Bangladesh	1984	0.005	2,123	348	6.1
2	India	1961	0.050	2,355	387	6.1
3	Philippines	1963	0.200	2,375	880	2.7
4	Sri Lanka	1987	0.150	1,470	825	1.8
5	Indonesia	2005	0.100	10,000	1,000	10.0
6	Taiwan	1985	0.015	38,500	11,633	3.3
Total ASIA				10,000	1,000	10.0

Source: UU No. 24, September 22, 2005 ; and Garcia (1998, p. 40)
Note: Estimated exchange rate is Rp. 10,000-/US$

(c) The Merger Wave of PD BPR BKK

Patten & Rosengard (1991) categorized the district credit institution (*Badan Kredit Kecamatan* , BKK) development into five overlapping but district phases, they are:

Table 3-14: Five development phases of the BKK from 1970-1989

No.	Period	Development Phase	Number of BKK/BPR
1	1970-1975	Creation of BKK units	432
2	1975-1979	Survival of the fittest	485
3	1979-1981	Rehabilitation	486
4	1981-1986	Growth & Institutionalization	497
5	1986-1989	Consolidation & diversification	499

Source: Patten, R. H & Rosengard, J. K., (1991) Patten & Rosengard (1991) mentioned two successful rural banking institutions in Indonesia i.e. (1) district credit institution (BKK), and (2) BRI unit. These institutions have been profitable and therefore sustainable.

After five phases mentioned in Table 3-14, two additional development phases of PD BPR BKK are proposed here: (6) Institutional up-grading 1989-2000, and (7) Merger wave starting from 2000.

The sixth phase is the institutional building of BKK characterized by conversion of BKK (as MFI non BPR) into BPR BKK with the same legal entity, that is, regional company (Perusahaan Daerah, PDP). Not all BKK are eligible for conversion that give the ultimate result of 350 PD BPR BKKs and 160 PD BKKs. The driving force is that the regulators, especially Bank Indonesia and the Ministry of Finance declare that all kind of deposit receiving institutions are strongly advised to become banks. The underlying legislation is the act No. 71/1992 that encourages all MFI's owners to convert the MFI non BPR into a BPR if it had been established before March 25, 1991. The MFI could apply for a license to be a BPR with a minimum required capital of Rp. 500 million. This opportunity was available for five years, until October 29, 1997.

The overall PD BPR BKKs cover a proportion in funding is 81,6% and in credit is 82,3%, and therefore the overall PD BKKs cover proportion in funding is 18.4% and in credit is 17.7% respectively. Meanwhile, in average business size (asset) of the PD BKK is as big as 50% of PD BPR BKK.

The seventh phase is the merger wave. The idea of merger among PD BPR BKKs started to emerge in year 2000s and it had been widespread in PD BPR BKK's management circle.. Since then, limited information about the progress of the merger ideas available publicly until year 2003. Generally speaking, the existent of business failures as one of the driving force of merger, although it may not be stated publicly. Normally, business owners prefer to announce the objective of merger to create efficiency and increase competitiveness in the market place. In fact, in 2000 the publicly available information (such as Suara Merdeka and Kompas) quote there were 327 units (64%) of BKK and BPR BKK were financially healthy and quite healthy. The remaining 183 units (36%) categorized as quite unhealthy and unhealthy. In 2002, there were an improvement financial in which 77% of them were healthy and quite healthy

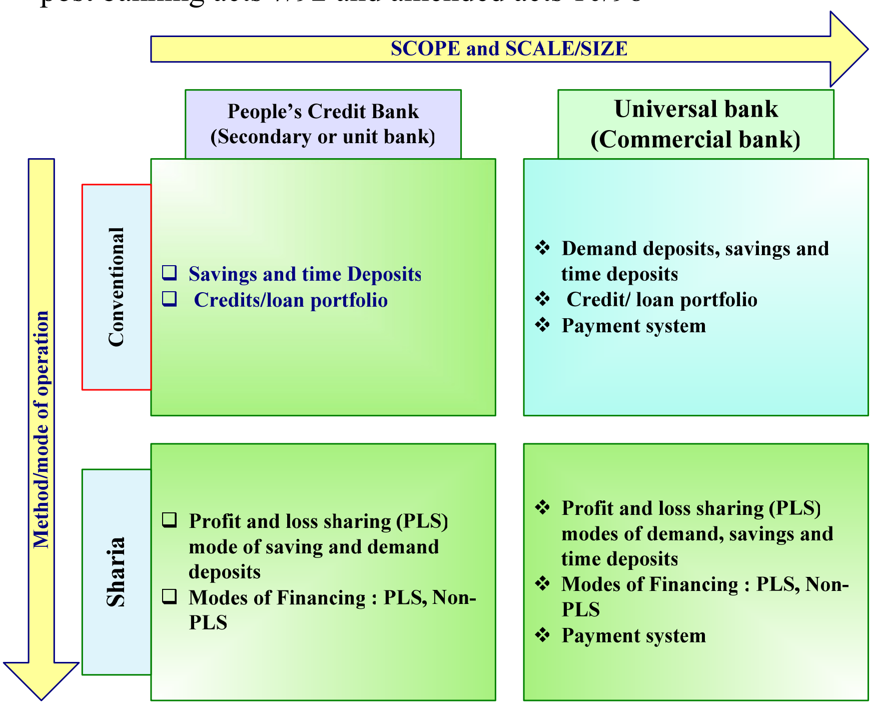
In September 2003, some PD BPR BKKs were under special supervision of Bank Indonesia, because their CAR was less than 0% (negative). Even on October 16, 2003, 15 PD BPR BKKs and one BPR non BKK were under special surveillance of

Bank Indonesia too, because their CAR was less than 4%. At that time, Moejono, the office coordinator of Bank Indonesia Semarang, conveyed publicly about the merger idea for PD BPR BKK. Through the merger mechanism, the 350 BPR BKKs to become 32 BPR BKKs, approximately as much as total regencies. As a result, the merged BPR BKKs will reduce the total management and supervisory boards. The main constraint that hamper merger process of PD BPR BKK is the lack of availability of additional capital funds. Meanwhile, the Bank Indonesia decree No. 32/52/KEP/DIR about the rules of the BPR merger, consolidation, and acquisition has ready to facilitate the merger. Since the year of 2004, there have been series of PD BPK BKK merger announcement through local news paper (Suara Merdeka) and national news paper (Kompas).

3.5 Dual Banking System

The Indonesian government promotes a dual-mode banking system that is applied for both universal (commercial) banks and BPR. The first is of a conventional banking system and the second is a sharia (Islamic law) banking system. Bank of Indonesia is in charge of expediting the expansion of the sharia bank.

Figure 3-5**:** Categories of bank by scope, scale/size, and mode of operation (system) post banking acts 7/92 and amended acts 10/98



Source: Author's figure

The dual-mode banking system began in 1991, when PT. Bank Muamalat Indonesia (BMI) was in operation. The sharia bank is different from its counterpart in mode of operation. It operates through profit and loss sharing (PLS) and mark-up financing system that apply to deposit and financing transactions. However, its scope of operation is broader than a conventional bank covering conventional bank and multi finance institution modes of operations. To speed up the rate of growth of sharia banks in the country with a predominantly Moslem population, special attention has been given by the Indonesian government in some aspects:

1. The Sharia Bank Development Bureau has been established (May 2001) under the Board of Governor of Central Bank Indonesia No. 3/1/PDG dated April 27, 2001. The authority given to this Bureau consists of (a) research and development, (b) regulations and supervision of business activities, and (c) granting licenses for the establishment of new banks.
2. Training and upgrading director and senior officers, etc.
3. Information dissemination through public expose in several big cities
4. Finalization of tailor-made standards of Capital Adequacy ratio, General Accounting Principle.

Considering some salient features of the banking system as described above, there are four major categories of banks in Indonesia as follows:

The first commercial Islamic bank (Bank Muamalat Indonesia) emerged in the capital city, Jakarta, and commenced operations in March 1992. The development of Sharia banks in Indonesia within a decade can be seen in Table 3-15

Table 3-15: Key figures of two categories of sharia banks in Indonesia, 1992-2003

Particular	1992	1999	2000	2001	2002	2003
A. Number of Units						
Sharia Commercial Bank	1	2	2	2	2	2
Sharia Business Units	0	1	3	3	6	8
Number of offices	1	40	62	96	127	255
Sharia BPR	9	78	78	81	83	84
Total number of offices	11	121	140	177	210	377
B. Market Share (%)						
Assets	na	na	0.17	0.25	0.36	0.61
Third Party Funds	na	na	0.15	0.23	0.35	0.55
Financing	na	na	0.40	0.57	0.80	1.09

Source : Bank Indonesia annual reports, 1996/97-2004, Supervision of the Banking Industry report, 2004

Within a decade, the number of offices increase sharply from 11 offices in 1992 to 377 offices in 2003. At the same time, the market share of assets, financing ("loan"), and third party funds (deposits) still less than 1,5 % of total banking system. It means, conventional banks remain dominate the banking market. As per December 31, 2004, the sharia BPR accounted for 84 head offices they have successfully accumulated their assets up to Rp. 85.2 billion and own 2.85% of the total BPR assets in Indonesia.

By the end of 2003 in Central Java, there were 20 out of 2.247 commercial bank offices were commercial sharia bank offices. The market share of sharia banks both commercial and BPR were still low accounted for less than 1% of deposits, and their financing share was around 1,5 % of total loan. The intermediary function as indicated by fund deposit ratio (FDR) of commercial sharia bank was high of about 158 % suggesting that the bank was lacking of third party fund. At the same time, total sharia BPRs performed better in intermediary function with FDR accounted for 109,4%. During the survey, there was only two BPRS but in 2005 became 5 units.

END NOTES

[1] The survey is out of 174 respondents drawn from small enterprises situated in Semarang and Medan (ADB, 2001).

[2] It is known as Kredit Usaha Kecil (KUK), which has been frequently modified since a law was enacted in 1990. At the outset, the KUK was in the form of commercial loans of up to Rp. 200 million. Bank Indonesia Regulation Number 3/2/PBI/2001 dated January 4, 2001, concerning credit provisions for small-scale business loans.

[3] Bank Bukopin and cooperatives / microfinance institutions signed a Memorandum of Understanding to establish Swamitra. Swamitra is a cooperative legal business entity operating as a depository institution that collects savings and time deposits and extends credit to clients. It is an autonomous business unit of the cooperatives or microfinance institutions in partnerships with Bank Bukopin. The owners of Swamitras are cooperatives/MFIs. Bukopin is the only cooperative commercial bank in Indonesia, of which the majority of the shareholders are various prominent secondary cooperatives in Indonesia and the Indonesian government.

[4] Mr. H. Mardiyanto, the governor of Central Java hopes the banking system provides soft (low interest) loans and management assistance to the SMEs (January 20, 2003).

[5] Bank Indonesia Regulation number 3/1/PBI/2001 dated January 4, 2001, concerning a microcredit project was subsequently amended by Bank Indonesia Regulation number 3/8/PBI/2001 dated April 25, 2001, and number 3/16/PBI/2001 dated October 3, 2001.