

Islamic Microfinance in Indonesia

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Abstract:
Islamic Microfinance in Indonesia

Indonesia, the largest Muslim country, has a highly differentiated micro- and rural finance sector which has evolved over more than a century. Islamic finance has emerged in 1991, comprising Islamic commercial banks and banking units, rural banks, and financial cooperatives. In this study we deal with the emerging Islamic microfinance sector in Indonesia, particularly rural banks and financial cooperatives: how they have evolved, how they compare with conventional institutions, and what their prospects for growth are.

Islamic finance, after 13 years, accounts for a mere 0.74% of total assets of the banking sector. However, since Bank Indonesia gave official recognition in 1998 to a dual banking system, conventional and Islamic, interest in Islamic meso and macro finance has spread among commercial banks, fuelled by low rates of non-performing loans, and the share of Islamic commercial banks more than quadrupled during 2001-2003: from 0.17% to 0.74%.

Islamic rural banks (BPRS) are under the same effective prudential regulation and supervision as commercial banks and conventional rural banks (BPR). After a promising start in the early 1990s, their development has almost come to a standstill. Despite the fact that they had only two years less than conventional BPR, they have attained a mere 4% of the number and 1.5% of the assets of the rural banking sector.

Islamic financial cooperatives (BMT) suffer from the same regulatory and supervisory neglect as the rest of the sector. After a period of rapid growth during most of the 1990s, they are now in decline, with perhaps not more than one-fifth in good health. Fresh money pumped into the sector without effective regulation and supervision will contribute to their downfall, as has been the case in the state-supported cooperative sector.

Options: Islamic microfinance, lacking popular demand and Islamic banking expertise, is not off to a promising start in Indonesia. Only commercial banks appear to be able of acquiring the art of Islamic banking by training young and dynamic people, but lack experience in Islamic microfinance. Islamic, unlike conventional, rural banks, have failed to prove themselves as effective and efficient providers of microfinance services; Islamic, like conventional, cooperatives are an outright menace to their shareholders and depositors, who risk losing their money. On the basis of 13 years of experience with Islamic finance in Indonesia, decision-makers in favor of promoting Islamic financial services are now confronted with two major options:

- Focusing fully on Islamic commercial banks in Indonesia and assisting them to establish branch networks with Islamic microfinance products.
- Re-assessing in a participatory process the challenges and realistic opportunities of Islamic rural banks and cooperatives, taking into consideration the lack of broad popular demand, be it from poor or non-poor, and the lack of dynamic growth.

Opportunities: We recommend to decision-makers in Islamic organizations, government agencies and donor organizations to cautiously examine the following opportunities for the development of a healthy Islamic financial sector in Indonesia:

- (1) **Islamic commercial banks**, in setting up branch networks of Islamic MFIs, may learn, with good prospects, from the rich experience of successful microfinance strategies and institutions within Indonesia, particularly the BRI Microbanking Division, one of the most successful microfinance programs in the developing world.
- (2) **Islamic rural banks** need to be revamped if they are to play a more than marginal role in Indonesia. This will require an overall development plan for the BPRS sector mutually agreed upon by all stakeholders and a strong banking association to provide a full range

of support services to their members. Some of the more successful Islamic rural banks may serve as exposure training sites to future managers. Auditing should be mandatory regardless of size.

- (3) **Islamic cooperatives** suffer from much the same set of problems as the whole cooperative sector. There is little chance for any intervention to be successful in the short run. They need a system of prudential regulation, mandatory auditing, and effective supervision by an appropriate financial authority. They should be fully financed through equity and savings deposits of members; only healthy and well-supervised cooperatives should be permitted to collect deposits from non-members. They need strong associations and federations to provide a full range of support services to their members.

A note on Islamic finance in the province of Aceh after the Tsunami:²

Of all areas devastated by the Tsunami, the province of Aceh has been hardest hit. Providing relief and reconstructing the livelihoods of the surviving victims is the immediate task; reconstructing the physical and institutional infrastructure will have to come next. If the efforts at reconstruction are to lead to sustainable development, rural and microfinance will have an important role to play. For political reasons, Aceh has been isolated in the past from mainstream development. The challenge is thus not just reconstructing, but laying the foundations for a sound system of rural and microfinance institutions. All those impoverished by the floods, as well as everybody else, need access to sustainable financial institutions for depositing savings including relief benefits and obtaining credit. As I have shown elsewhere (*Seibel 2003a*), relief benefits are likely to be wasted, or limited in their effectiveness, if victims have no access to financial services. The people of Aceh adhere strongly to the principles of Islam, including those of Islamic finance. Despite its isolation, Aceh already has 5 Islamic rural banks and 76 Islamic cooperatives, of which less than 20 are functioning. This is a beginning, but not an adequate structure of Islamic finance. Building strong Islamic financial institutions in Aceh could be of enormous benefit to the reconstruction and development of the province. Thereby Aceh could become the province benefiting most from the results of this study on the positive and negative experience of Islamic finance in Indonesia.

² This note was prepared in January 2005. Since mid-2005 GTZ has been supporting the *Reconstruction and Development of the Microfinance System in Nanggroe Aceh Darussalam (NAD), Indonesia*.

Table of contents

Abstract	ii
Table of contents	iv
USD/IDR Exchange Rates, 1992-2004 Note on transcriptions	Vi vi
Introduction	1
1. Financial sector framework	
1.1 Financial infrastructure	4
1.2 Macroeconomic and policy framework	4
2. Principles and products of Islamic finance	5
3. Evolution and structure of Islamic finance in Indonesia	
3.1 Typology of Islamic financial institutions in Indonesia	7
3.2 Institutional and regulatory framework: mainstreaming Islamic banking	8
3.3 Origins and development of Islamic commercial and rural banks	9
3.4 Conventional and Islamic commercial banking: a comparison	10
3.5 Development of Islamic financial cooperatives	11
4. Islamic rural banks (BPRS)	
4.1 Conventional and Islamic rural banks (BPR and BPRS): a comparison	12
4.2 Regional distribution	13
4.3 Mission, ownership and governance	14
4.4 Delivery system	15
4.5 Market and outreach	15
4.6 Total assets and sources of funds	16
4.7 Financial services	17
4.8 Economic performance	17
4.9 Affiliations and support	18
4.10 Perceptions of Islamic banking by the public	19
5. Islamic cooperatives (BMT. BTM)	
5.1 Conventional and Islamic cooperatives: a comparison	21
5.2 Sample BMT: origin and history	23
5.3 Regional distribution	23
5.4 Mission, legal status and governance	25
5.5 Delivery system, market and outreach	26
5.6 Total assets and sources of funds	26
5.7 Financial services	27
5.8 Economic performance	27
5.9 Affiliations and support	28
6. Summary, assessment and recommendations	
6.1 Summary and assessment	31
6.2 Recommendations	40
<i>A note on Islamic finance in the province of Aceh after the Tsunami</i>	43
References	44

Annexes :	
1: Consolidated balance sheet & income statement of Islamic rural banks, 2003	46
2: List of Islamic rural banks (BPRS), June 2004	47
Appendices :	
1: Financial infrastructure	49
2: Development of conventional and Islamic rural banks in Indonesia, 1993-2003	52
3: Evolution and structure of Islamic finance in Indonesia	53
4: Islamic rural banks (BPRS)	54
5: Islamic cooperatives	61

Indonesia macroeconomic data, 2001-2003

	2001	2002	2003
GDP growth rate	3.5	3.7	4.1
Population (million)	208.9	212.0	215.2
Percent poor			17.4
GDP per capita in US \$	685	815	969
Inflation rate (CPI) in %	12.6	10.0	5.1
Exchange rate to the US\$: average	10,255	9,318	8,572
Exchange rate (median) to the US\$: end of year	10,446	8,938	8,451
Financial deepening (M2/GDP) in %	57.5	54.9	53.5
Average bank lending rate in % (Working capital credit only):	19.19	18.25	15.07
Average bank deposit rate (one-month fixed deposits) in %	16.07	12.81	6.62
SBI (1 month) rate [TB rate]	17.62	12.93	8.31

USD/IDR Exchange Rates, 1992-2004

	Year End	Year average
1992	2,067	2,033
1993	2,102	2,089
1994	2,199	2,163
1995	2,287	2,247
1996	2,344	2,329
1997	3,646	2,776
1998	8,000	10,248
1999	7,100	7,787
2000	9,675	8,527
2001	10,400	10,271
2002	8,940	9,318
2003	8,451	8,572
2004	9,305	

Note on transcriptions:

Key Islamic banking terms are based on Islamic law written in Arabic. Transcriptions vary widely in Indonesia and elsewhere; there is no authoritative standard of transcription. In chapter 2.3, the key terminology is therefore presented in Arabic, the most common international transcription, and widely used transcriptions as used in Indonesia. An example are the various transcriptions of the term for Islamic law: شريعة, shar'iah, Syariah, sharia. The Arabic terms and international transcriptions have been provided by Dr. Omar Imady, Damascus.

Islamic Microfinance in Indonesia

Introduction

Islamic banking based on Islamic law, sharia, started just about 40 years ago. Few countries have adopted Islamic banking as its sole mode of operation, among them Iran and Sudan. Other predominantly Islamic countries have adamantly stayed away from Islamic banking; yet some have tolerated niches of Islamic microfinance as a concession to local culture, like Syria for example³. In recent years, an increasing number of countries in both the developed and the developing world have seen the emergence of Islamic banks, banking units and Islamic products. However, this growth has not been mirrored in the microfinance sectors of most countries with Islamic financial services. This is probably due to Islamic banking principles like partnership and profit-sharing with investors, which require adequate book-keeping and auditing, or, as an alternative, charitable credit to the poor without profit-sharing. As a result, the vast majority of the poor have remained without access to finance in these countries.

In Indonesia, the largest Muslim country, Islamic finance has evolved since 1991, comprising Islamic commercial banks, commercial banking units, rural banks, and financial cooperatives. Indonesia also has one of the most differentiated micro- and rural finance sectors among developing countries, comprising both formal and non-formal financial institutions. In this study we deal with the emerging Islamic microfinance sector in Indonesia, particularly rural banks and financial cooperatives: how they have evolved, how they compare with conventional microfinance institutions, and what their prospects for growth are. The objective of this study is contribute to international awareness of Islamic microfinance by providing an overview of the characteristics and current practices of sharia institutions involved in providing financial services to poorer segments of the Indonesian population.

Field work in Indonesia, limited to western Java due to time constraints, was carried out between 24 May and 5 June 2004. Main sources of information were the Islamic banking directorate of Bank Indonesia, the Islamic banking association ASBISINDO, the agency for the promotion of Islamic cooperatives PINBUK, the Ministry of Cooperatives and Small Enterprises, and case studies of five Islamic rural banks (BPRS) and four Islamic savings and credit cooperatives (BMT). It should be noted here that there is no reliable statistical information on Islamic cooperatives, quite in contrast to Islamic commercial and rural banks, which are supervised by the central bank. Other sources of information are listed in the references and in Annex 1. Logistical support was efficiently provided by the GTZ project *Promotion of Small Financial Institutions (ProFI)*. We gratefully acknowledge these invaluable inputs and services.

The study has greatly benefited from the collaboration of Wahyu Dwi Agung, one of the early promoters of Islamic banking in Indonesia and head of ASBISINDO, who has freely provided his insights and contacts.

³ Cf. Imady & Seibel, 2003

1. Financial sector framework

1.1 Financial infrastructure

Indonesia has one of the most differentiated banking and microfinance sectors of any developing country. After the establishment of the first rural bank in 1895, a three-tiered financial system of national, district and village institutions evolved. At the top has been a century-old agricultural bank, now known as Bank Rakyat Indonesia (BRI). At the community level were two types of village banks, specialized on banking-in-kind and banking-in-money. As early as 1910, there were over 13,000 rural banks, comprising 12,542 rice banks and 585 money banks. Since then, money has gradually replaced kind. After more than a hundred years of evolutionary growth, the banking sector now comprises 138 commercial banks with a total of 7,730 bank offices (excluding the BRI units); and 2,134 rural banks (BPR). The rural and microfinance sector comprises 53,500 units, including 6,300 formal and 47,200 semiformal microfinance units (see *App. 1 Table 1*). Most notable among them are some 4000 BRI Units (formerly *unit desa*), presumably the developing world's most successful rural microfinance providers. They account for 74% of microsavings and 39% of microloans. In addition, there are some 800,000 channeling groups and uncounted numbers of rotating savings and credit associations (*arisan*) of indigenous origin. In recent years new efforts have been made to extend the protection of the law to financial institutions of the poor and near-poor by preparing a draft law for MFIs (*Lembaga Keuangan Mikro, LKM*).⁴ Despite the extraordinarily high level of institutional differentiation, large numbers of households reportedly are without access to formal or semiformal finance.

The banking law in Indonesia recognizes two types of banks: commercial banks (*Bank Umum, BU*, lit.: universal banks) and rural banks (Bank Perkreditan Rakyat, BPR, lit.: people's credit banks). **The commercial banking sector**, which nearly collapsed during the 1997/98 crisis, has recovered due to major consolidation efforts of the government, which included numerous bank closures and mergers. From 1999 to 2003, the gross non-performing loan ratio (NPL) went down from 32.8% to 8.1% and net NPL from 7.3% to 1.8%. During the same period, the banks went from losses of 7.5% to (pre-tax) profits of 2.1% of total assets; the capital adequacy ratio (CAR) went from -8.1% in 1999 to 20.7% in 2003. However, overall growth of the commercial banking sector is still sluggish.

Rural banks (BPR), which are one of the two types of microfinance institutions dealt with in this study, are based on the law of 1988 (*PAKTO27*). They consist of newly established BPR (*BPR baru*) and pre-existing rural banks converted into BPR (*BPR lama*). In the context of financial liberalization, the law was enacted in an effort to rationalize the highly complex rural finance sector, with the objective of bringing existing institutions under the umbrella of prudential regulation and supervision, providing a framework for the establishment of new financial institutions with private capital, and extending the outreach of financial institutions to the poorer sections of the rural and peri-urban population, thereby lessening their dependence on private moneylenders. Minimum capital requirements for BPR were uniformly set at Rp 50m, equivalent to US\$ 29,000 in 1988 (\$21,000 in 1996 as a result of devaluation). Most of the newly established BPR were set up by private owners.

There are now (Dec.2003) 2134 licensed and regulated BPR. While they account for a mere 1.0% of total banking assets, their asset growth during the last three years has exceeded that of the commercial banking sector by a wide margin (see *App. 1 Table 2*). During their lifetime of fifteen years, BPR expanded at widely differing rates in three phases:

Phase 1: During the initial five-year period, 1989-93, BPR grew at an average number of 342 BPR per year.

⁴ Act XXX of 2001, draft dated 14/9/2001. This is a participatory effort coordinated by a Tim Inisiatif, first headed by Bank Indonesia and now by a newly created microfinance unit in the MoA. World Bank, ADB and GTZ are involved.

Phase 2: During the following six years, 1994-99, growth slowed to 120 BPR per year.⁵ As a surprise to many, the Asian Financial Crisis not only failed to impede further growth; if anything, it inspired further growth: with 153 additional BPR established in 1997, 122 in 1998 and 165 in 1999 (averaging 147 per year during the three main crisis years). As observers noted, “the BPR have come through the financial crisis in very good shape and are now reaching larger numbers of customers in a sustainable manner” (ADB 2003 Suppl. App. C: 6-7).

Phase 3: The year 2000 marked a turn-around, initiating a consolidation period. Due to increased minimum capital requirements, more rigid supervision by the central bank, the enforcement of performance standards and the closing of non-performing BPR, their number declined. During the four-year period 2000-03, the average annual decrease in the number of BPR was 73. Until 2003, BI had revoked the licenses of 193 BPR. Evidently, BI not only regulates but also effectively supervises the BPR, enhancing prudential banking and revoking licenses if banks do not comply.

There are still large numbers of rural banks expected to comply with registration requirements and obtain a BPR license, but unable to come up with the required capital. 92 applications for new BPR are reportedly in the pipeline.

The shrinking numbers of BPR during the last three years present a dismal picture. Yet, while numbers shrank, assets grew rapidly, indicating an impressive performance during this period of consolidation, reaching total assets of Rp 12.90tr, or on average Rp 6.05bn or US\$ 715,300 per BPR as of Dec. 2003. During the three-year period from December 2000 to December 2003, their total assets grew by 173%, deposits by 189%, and credit by 154% – compared to growth rates of 11%, 25% and 49%, respectively, of the commercial banking sector.⁶ Given an average annual inflation rate of 9.3% during that period, the growth rates of commercial banks were negative, while those of the BPR were strongly positive. In 2000, 2001 and 2002, BPR pre-tax profits stood at 2.5%, 3.3% and 3.6%, respectively, of total assets.

Excess liquidity has been a major problem of the commercial banking sector in Indonesia. As of November 2003, banks mobilized Rp 875.4tr (US\$103bn) in deposits, but lent only Rp 475.7tr (\$56bn), generating Rp 400tr (\$47bn) in excess liquidity. Indonesia’s problem is how to lend, not lack of funds. The loan-to-deposit ratio (LDR) has been improving in recent years: from 26.2% in 1999 to 43.7% in 2003, but is still low. This problem also applies to the major rural and peri-urban microfinance provider, the BRI Microbanking Division. Since 1990,

⁵ The picture is complex, depending on whether we look at total numbers of BPR, numbers by origin, and total assets. There are three major origins of BPR: newly established institutions, converted conventional BPR, and converted other microfinance institutions. Unfortunately, the reported figures by origin do not conform to the overall figures on BPR reported above (see Table ___). The following information on newly established and converted BPR is therefore only indicative. In 1990, 329 BPR had been newly established (56%), and 257 existing institutions (44%) had acquired a BPR license, bringing the total to 586 BPR. By 1992, the total number was 1,021: the number of new BPR had surged to 848 (83%), while the number of converted BPR had declined to 173 (17%), indicating that a good number of them was not able to live up to Bank Indonesia standards. During the eight-year period until the end of 1996, the total number of BPR had reached almost 2,000: 1,343 new BPR (68%) and 644 converted BPR⁵ (32%), totaling 1,987. The financial crisis brought the growth of the number of new BPR almost to a standstill; their total number continued to grow, but mainly through the conversion of existing LDKP, previously under provincial law, into BPR under national banking law. By June 2002, the total number of BPR had grown to 2,213: 1,365 new BPR (62%) and 848 converted BPR (38%) [151 Bank Pasar/Bank Desa, 133 BKPD and 564 LDKP]. BI has played a decisive role in closing poorly performing BPR and in assisting various MFIs to transform into BPR. By Dec. 2003, the total number of BPR had declined to 2134. (ADB Suppl. App. C: 6-7; Steinwand 2001: 172)

⁶ Inflation rates stood at 12.6% in 2001, 10.0% in 2002 and 5.1% in 2003, averaging 9.3% p.a. This means that real growth rates of total assets and deposits of the commercial banking sector were negative during that time period, while all three growth rates of the rural banking sector were highly positive in real terms.

the BRI units have produced large amounts of excess liquidity from rural savings, consistently exceeding \$1bn per year throughout and after the Asian Financial Crisis; as of December 2003, its LDR was 47.6%, close to the commercial banking average. There is thus little, if any, justification for donors to pour hard-currency liquidity into the national soft-currency intermediation circuit.

Smaller financial institutions have had the opposite problem: **a shortage of liquidity**. Rural banks (BPR), the largest entities among the small financial institutions, with consolidated deposits of Rp 8.89tr and loans outstanding of Rp 9.12tr, had a slight liquidity shortage of Rp 0.23tr and an LDR of 103% as of Dec. 2003. Among the yet smaller non-bank financial institutions, with drastically lower average loan sizes, the 4,482 BKD and 1,428 LDKP, with total deposits of Rp 242bn and total loans outstanding of Rp 521bn, had a severe liquidity shortage of Rp 279 bn and an LDR of 215%. Similarly, the 40,527 financial cooperatives, with total consolidated deposits of Rp 1.66tr and loans outstanding of Rp 4.79tr, have a liquidity gap of Rp. 3.13tr and an LDR of 189%. The latter figures conceal major differences between the various types of cooperatives: the private credit unions and the Islamic cooperatives are quite balanced, with LDRs of 109% and 111%, respectively; while the government-pampered USP and KSP have ratios of 314% and 469%, respectively. (Data ~2000, see *App.1 Table 1*)

Two **major issues** and challenges in microfinance have remained:

- how to use the existing massive excess liquidity in the banking sector to extend financial services to those segments of the rural population without access;
- whether, and how, to extend recognition, depositor protection, regulation and (delegated) supervision to large numbers of small financial institutions.

These issues apply to both conventional and Islamic financial institutions in Indonesia.

1.2 Macroeconomic and policy framework

There is a considerable correspondence between today's policy concerns and those at the beginning of the 20th century: an emphasis on demand-oriented financial services, institutional viability, sustainability of the system as a whole, as well as experimentation to expand services to the poor with individual and group technologies.⁷ Following the oil price increase of 1973 and again in 1979, Indonesia invested substantial amounts in development, using directed credit as one of its tools. The decline in oil prices since 1982 initiated an era of liberalization, shifting the prime mover of development from government to market forces. Inflation fell from 20% during 1973/74 to 5.7% during 1985/86: an important prerequisite for financial market liberalization. In microfinance, the policy environment evolved rapidly during the 1980s and 1990s, highlighted by:

- (a) full interest rate deregulation and elimination of credit ceilings in 1983 (preceded by the oil crisis of 1982), which gave birth to the reform of the BRI unit system in 1984
- (b) institutional liberalization in 1988 (preceded by the oil crisis of 1986), which led to the rise of rural banks (BPR) as part of the formal financial sector
- (c) the phasing out of 32 out of 36 subsidized credit programs in 1990
- (d) a new banking law in 1992, acknowledging two types of banks: commercial banks and rural banks
- (e) 1997-2002: financial sector crisis management geared to prudential regulation and effective supervision.

⁷ „Interest rates had been set high enough not only to cover costs but to increase the institutions' equity base through retained earnings (BKD). Subsidies were limited to initial start-up support after which the institutions had to become viable. Maturities and repayment schedules of the loan products were designed according to the needs of the customers. Unsecured, 'character-based' lending was common... Innovative techniques like group-lending and joint liability were developed and tested (and given up again). Strict loan enforcement was common..." (D. Steinwand, *The Alchemy of Microfinance*. Berlin 2001: 103)

These policies proved tremendously successful: during 1979-96 GDP grew at 7% p.a.; the percentage of poor fell from 60% in 1970 to 11.5% in 1996.⁸ The process of steady growth was unexpectedly interrupted by the Asian financial crisis, *krismon*, which revealed (i) the dangers of financial deregulation without effective supervision (meaning: *enforcement* of prudential regulation) and (ii) the risks of excessive short-term external borrowings. At the same time, it revealed the fragility of poverty alleviation, leading to a doubling of the number of poor, mostly from the realms of the near-poor, to around 20% of the population by 1999.⁹ Since 2000, there have been clear signs of recovery. From 2001 to 2003 GDP grew at rates between 3.5% and 4.1%, while the inflation rate fell from 12.6% to 5.1%.¹⁰

2. Principles and products of Islamic finance

The principles of Islamic finance are laid down in Islamic law, the sharia, شريعة. Islamic finance, comprising financial transactions in banks and non-bank financial institutions formal and non-formal financial institutions, is based on the concept of a social order of brotherhood and solidarity. The participants in banking transactions are considered business partners who jointly bear the risks and profits. Islamic financial instruments and products are equity-oriented and based on various forms of profit and loss sharing. As Islamic banks and their clients are partners, both sides of financial intermediation are based on sharing risks and gains: the transfer of funds from clients to the bank (*depositing*) is based on revenue-sharing and usually calculated ex post on a monthly basis¹¹; the transfer of funds from the bank to the clients is based on profit-sharing (*lending, financing*), either at a mutually agreed-upon ratio as in the case of *mudarabah* or at a mutually agreed-upon fixed rate. Such ratios and rates vary between institutions and may also vary between contracts within the same institution, contingent upon perceived business prospects and risks. Islamic banking finances only real transactions with underlying assets; speculative investments such as margin trading and derivatives transactions are excluded. Lending, or financing, is backed by collateral; collateral-free lending would normally be considered as containing a speculative element, or moral hazard. Similarly, to avoid speculation and moral hazard, normally only investors with several years of successfully business experience are financed. The paying or taking of *riba*, interest, is prohibited. The same principle of partnership is applied to Islamic insurance. It is based on a collective sharing of risk by a group of individuals whose payments are akin to premiums invested by the Islamic banking institution in a *mudarabah* arrangement for the benefit of the group.

The fundamental principle of solidarity at the societal level finds its expression in a special category of financial products without remuneration, *qard*. Investors without adequate business experience who are considered high-risk may receive a moderate amount of financing on *qard hasan* terms, free of any profit-sharing margin, but usually repaid by instalments and backed by collateral. Similarly (but rarely in Indonesia), depositors may save in an Islamic financial institution without receiving a remuneration, usually with the expectation that the funds are used for social or religious purposes. In inflationary economies, *qard* deposits and financings pose unresolved problems. A typology of Islamic financial products is presented below.

⁸ The World Bank, Indonesia Country Assistance Note, March 29, 1999.

⁹ Official figures for 1999 vary from 18.2% (Susenas, Central Bureau of Statistics) to 27.1% (Smeru).

¹⁰ Also, interest rates declined: average bank lending rates for working capital credit fell from 19.2% to 15.1%, one-month fixed deposit rates from 16.1% to 6.6% and one-month treasury bills (SBI) from 17.6% to 8.3%.

¹¹ In one sense, depositors are treated like shareholders; in another sense, they are treated better than shareholders, as they share in the revenue and not the profit or loss.

Table 3.1: Typology of Islamic financial products

(1) Financing products

Profit sharing financing products:	
Musharakah Musyarakah مشاركة	Equity participation, investment and management from all partners; profits are shared according to a pre-agreed ratio, losses according to equity contributions.
Mudrabah مضاربة	A profit-sharing partnership to which one contributes the capital and the other the entrepreneurship; or the bank provides the capital, the customer manages the project. Profit is shared according to a pre-agreed ratio
Qard Hasan Qard al-Hasanah حسن	Charitable loans free of interest and profit-sharing margins, repayment by instalments. A modest service charge is permissible
Wakalah وكالة	An authorization to the bank to conduct some business on the customer's behalf
Hawalah حوالة	An agreement by the bank to undertake some of the liabilities of the customer for which the bank receives a fee. When the liabilities mature the customer pays back the bank
Advance purchase financing products:	
Murabahah مرا بحة	A sales contract between a bank and its customers, mostly for trade financing. The bank purchases goods ordered by the customer; the customer pays the original price plus a profit margin agreed upon by the two parties. Repayment by installments within a specified period
Istithna' إستثناء	A sales contract between bank and customer where the customer specifies goods to be made or shipped, which the bank then sells to the customer according to a pre-agreed arrangement. Prices and instalment schedules are mutually agreed upon in advance.
Mu'ajjal Bai al Salam بيع مؤجل	Purchase with deferred delivery: A sales contract where the price is paid in advance by the bank and the goods are delivered later by the customer to a designee
Ajaar Ijarah Ijarah Mutahia Bittamlik أجا	Lease and Hire Purchase: A contract under which the bank leases equipment to a customer for a rental fee; at the end of the lease period the customer will buy the equipment at an agreed price minus the rental fees already paid.

(2) Deposit products

Wadi'ah وديعة	Sight deposits, including current accounts (<i>giro wadi'ah</i>)
Mudrabah مضاربة	Deposit products based on revenue-sharing between depositor and bank, including savings products withdrawable at any time and time deposit products
Qard al-Hasanah حسن	Unremunerated deposit products, usually for charitable purposes (<i>widespread in Iran, but not found in Indonesia</i>)

(3) Insurance products

Tadamun, Takaful تضمن - تكافل	Islamic insurance with joint risk-sharing
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3. Evolution and structure of Islamic finance in Indonesia

3.1 Typology of Islamic financial institutions in Indonesia

Islamic finance is defined as a financial system based on Islamic law, **شريعة**, variously transcribed as shar'iah, sharia or Syariah. In Indonesia, Islamic finance is referred to as sharia finance when addressed to a wider audience (as in central bank publications) or Syariah finance when addressed to a predominantly Islamic audience. In this study, both terms are used. Islamic finance in Indonesia comprises two types of institutions:

- banking institutions, which fall under the banking law, and
- financial cooperatives.

There are three types of Islamic banking institutions, of which the first two fall into the legal category of commercial banks:

- Full-fledged Islamic commercial banks: Bank Umum Syariah (BUS)
- Islamic banking units of commercial banks: Unit Usaha Syariah (UUS)
- Islamic rural banks: Bank Perkreditan Rakyat Syariah (BPRS)

The Indonesian banking law recognizes two types of banking institutions: commercial banks and rural banks (BPR), with widely differing minimal capital requirements. The Islamic commercial banks and commercial banking units are a subcategory of the commercial banks, the Islamic rural banks (BPRS) a subcategory of the rural banks (BPR). The subcategories are included in the respective banking statistics by the central bank.

The Islamic financial cooperatives in Indonesia are not part of the formal financial sector. They may be registered with the Ministry of Cooperatives or be unregistered; accordingly, they may be placed into the semiformal and the informal financial sector, respectively. As they are not formally regulated, the distinction is of limited relevance. Initiated by a group of Muslim intellectuals and promoted by PINBUK, they are generally referred to as BMT as a generic term. Their development has been favored by the Muslim organizations Nadhatul Ulama and Muhamadiyah, but were not established by them. Since 1999 when Muhamadiyah began to provide guidance and supervision through Pusat Pengembangan Ekonomi Muhammadiyah (PPEM), one of its departments, a differentiation has occurred:

- BMT Baitul Maal wat Tamwil, comprising about 95% of Islamic cooperatives, with affinity to Nadhatul Ulama (NU), with almost 40m members the largest Islamic mass organization in Indonesia; however, NU does not play an active role in guiding and supervising BMT. These are under the guidance of PINBUK; statistics on BMT usually include the BTM (unless otherwise stated).
- BTM Baitul Tamwil Muhamadiyah, comprising about 5% of Islamic cooperatives, guided since 1999 by Muhamadiyah, with some 25 million members the second-largest Islamic mass organization in Indonesia. BTM are informally supervised by PPEM.

BMT reportedly have a mixed commercial and social orientation, while BTM have a more definite commercial orientation.

The concept of microfinance is ambiguous in Indonesia. In a wider and internationally recognized sense, microfinance institutions (MFIs) include institutions of the formal, semiformal and informal financial sectors providing small-scale financial services to the lower segments of the population. Examples are the units of the BRI Microbanking Division and the rural banks (BPR) as part of the formal financial sector; various types of cooperatives and the so-called village banks (bank desa), which are part of the semiformal financial sector outside the regulation and supervision of the financial authorities; and a wide variety of self-help

groups, channelling groups and rotating savings and credit associations (ROSCAs, *arisan*) as part of the informal financial sector.

In a narrower sense, microfinance institutions loosely comprise a variety of semiformal financial institutions targeted by the draft law of September 2001 on Lembaga Keuangan Mikro (LKM), which literally means microfinance institutions. A number of cooperatives, larger self-help groups and associations of smaller ones refer to themselves as LKM in anticipation of the law, even though the future of that law is uncertain. The draft law does not include the microfinance institutions of the formal sector such as the BRI units and the rural banks (BPR) which fall under the banking law. In this report, Islamic microfinance comprises sharia rural banks (BPRS) and sharia cooperatives (BMT, BTM).

3.2 Institutional and regulatory framework: mainstreaming Islamic banking

Bank Indonesia (2002:16) has provided the following vision & mission of sharia banking development in Indonesia: "A sound sharia banking system that is competitive, efficient and compliant with prudential practices, and capable of supporting real economic sector through the implementation of share based financing and trades with real underlying transactions in the spirit of brotherhood and good deeds to promote well-being for all society." **The strategic objectives** of sharia banking development, according to Bank Indonesia (2002:5), include:

- High level of competitiveness while complying with sharia principles
- Significant roles in sustaining national economy and public welfare
- Global competitiveness through compliance to international operational standards

As of 1998 (Act. No. 10), Bank Indonesia gave official recognition, as part of the new banking act, to the existence of a **dual banking system, conventional and sharia-based**. The mainstreaming of Islamic banking was backed by Act No. 23 of 1999 concerning Bank Indonesia, which authorizes the central bank to also conduct its task according to sharia principles" (see chapter 2.1). Beyond this, the law does not specify any substantively different provisions for Islamic banking. In 1999 Bank Indonesia established a team of sharia banking, converted in 2001 into a bureau and in 2003 into a directorate, with the objective of monitoring the new segment of the banking sector. At national and institutional levels, Islamic finance is supervised by sharia supervisory boards (SSB). On the whole, Bank Indonesia (2002:11) states that there is a "lack of efficient institutional structure supporting efficient sharia banking operations" and suggests to develop the following:

- *Sharia auditor* to ensure the compliance of sharia banks with sharia principles
- *Communication Board (FKPPS)* to enable an effective coordination of the effort to improve public awareness and education for sharia banking
- *Institution for Sharia Financing Insurance* to provide financial protection to sharia banks against fraudulent practices by recommended customers
- *Sharia Finance Information Center* as a linkage between the real and the sharia finance sector
- *Special Purpose Company* to facilitate asset securitization for Islamic banks

Major stakeholders, according to Bank Indonesia (2002:5), are:

- Sharia commercial banks, sharia banking units and sharia rural banks
- BI as banking regulatory and supervisory authority
- National sharia council (DSN)
- Muamalat arbitration body (BAMUI)
- Other sharia financial institutions: Takaful (sharia insurance), cooperatives, BAZIS, and sharia security companies

- Other regulatory bodies: Ministry of Finance and the capital market regulatory body (BAPEPAM)
- Universities and educational institutions with sharia finance and economics programs,
- Sharia-related organisations and companies such as sharia economic society (MES), association of national sharia banks, Jakarta Stock Exchange,
- The general public.

3.3 Origins and development of Islamic commercial and rural banks

Beginnings: In 1990, a meeting of Ulama, ie Islamic scholars, was convened in Indonesia on the prohibition of riba, or interest, as demanded by the Koran (Qur'an). In 1991 a technical team was formed, and steps were taken to establish Islamic commercial and rural banks. The first four Islamic rural banks (BPRS) were licensed and almost immediately opened during the second half of 1991: three in the Bandung area and one in Aceh. Five more were licensed, and all but one of them opened in 1992. Approval for the establishment of the first Islamic commercial bank, Bank Muammalat Indonesia (BMI), was granted in 1991; the licence was obtained in May 1992. Toward the end of 1992, Asbisindo (Asosiasi Bank Islam Indonesia) was established, originally as an association of BPRS. In 1998, it was renamed Asosiasi Bank Syariah Indonesia comprising both rural and commercial banks as members, but keeping the original acronym.

Growth of Islamic commercial banking: A new phase of *Islamic commercial banking development* was initiated in 1999 when a second commercial sharia bank was established, Bank Syariah Mandiri.¹² In the same year, the first sharia unit of a commercial bank was established. By December 2003, the number of Islamic commercial banks still stood at two, while the number of commercial banking units had grown to eight, comprising a total of 255 banking offices. (Table 3.2) Most remarkable has been the doubling of the number of bank offices of the Islamic commercial banks and banking units between Dec. 2002 and Dec. 2003: from 127 to 255. This was paralleled by the near-doubling of banking assets from Rp 4.02tr to Rp 7.86tr – an increase of 96% in nominal and 91% in real terms. (Table 3.3)

Table 3.2: The evolution of Islamic commercial banks

No.	Phase	Period	Number of banks and Islamic units
1	Establishment, no institutional growth	1992-1998	1
2	Gradual expansion	1999-2003	10

Stagnating Islamic rural banks: The growth pattern of Islamic rural banks was quite different. After an initial period of gradual growth until 1996 when they reached a total of 71, their number almost stagnated, reaching 78 by 1998 and a mere 84 by 2003. During the four-year period, 1999-2003, the number of Islamic rural banks grew by a meagre 8% from 78 to 84, while the number of Islamic commercial banking offices grew more than fivefold from 40 to 255.¹³

Table 3.3: The evolution of Islamic rural banks (BPRS)

No.	Phase	Period	Number of Islamic rural banks
1	Gradual expansion	1991-1996	71
2	Slow-down of expansion	1997-1998	78
3	Stagnation	1999-2003	84

¹² Bank Mandiri, which owns Bank Syariah Mandiri as a 100% shareholder, acquired a small conventional commercial bank, Bank Susila Bakti, and converted it into a separate Islamic bank.

¹³ There are no statistics on the number of branches of rural banks. In our sample study of five BPRS, the average number of branches was 2.0. If we generalize this, we arrive at a total number of 168 BPRS branches and a total number of Islamic commercial and rural bank offices of 517.

During 2003 when Islamic commercial banks doubled their assets, the number of BPRS grew by only one unit, their total assets by a mere 16% (11% in real terms).¹⁴ (Table 3.5)

Table 3.5: Growth of Islamic banking, 1991-2003

<i>Type of Islamic bank</i>	1991	1992	1999	2000	2001	2002	2003
Commercial banks	0	1	2	2	2	2	2
Commercial banking units	0	0	1	3	3	6	8
No. of commercial banking offices	0	1	40	62	96	127	255
Rural banks	4	9	78	78	81	83	84
<i>Total number of institutions</i>	4	10	81	83	86	91	94
<i>Total number of offices (A)</i>	4	10	118	140	177	210	349
<i>Total number of offices (B) incl. rural bank branches</i>							517

Lack of popular demand: There is no indication that the establishment of Islamic banks in Indonesia was preceded by a broad popular demand for sharia-based Islamic financial services. This situation appears to have changed little. According to surveys carried out in several provinces with an average Muslim population of 97%, only 11% were found to understand products and benefits of sharia banking. Bank Indonesia (2002:10) thus concluded that,

“There is still a gap between needs and knowledge of sharia financial products and services. The gap could delay the success to mobilise potential public fund to investment because of low switching rate from potential demand to real demand. Furthermore, the gap will also make marketing and selling effort for sharia banking products and services more difficult.”

3.4 Conventional and Islamic commercial banking: a comparison

There are 138 commercial banks in Indonesia, among them two Islamic commercial banks: Bank Muamalat Indonesia and Bank Syariah Mandiri. In addition, there are eight Islamic banking units: Bank IFI, Bank Negara Indonesia, Bank Jabar, Bank Rakyat Indonesia, Bank Danamon, Bank Bukopin, Bank Internasional Indonesia and HSBC, the latter a foreign bank. Of particular relevance is the entry of HSBC as a foreign non-Islamic bank into Islamic banking operations, indicating that the prospects for Islamic banking in Indonesia are attractive to foreign investors.

In terms of numbers, the two Islamic commercial banks represent 1.4% of all commercial banks. If we treat the eight commercial banking units like separate commercial banks and add them to the total number, then the Islamic commercial banks and commercial banking units account for 6.8% of the total number of 146 banks and banking units. The Islamic bank offices account for 3.3% of all commercial banking offices if the BRI units are excluded, and for 2.2% if they are included. In terms of total banking assets and financial activities,

- Islamic banks and banking units represent a mere 0.74% of total banking assets, 0.64% of total deposits and 1.16% of total loans outstanding.

The share in total assets remains the same with or without rural banks; it also remains the same if we add financial cooperatives. While Islamic commercial banking thus represents but a small proportion of overall commercial banking in Indonesia, their growth in recent years has been phenomenal:

¹⁴ As of May 2004, one new sharia commercial bank (by converting Bank Tugu into Bank Mega Syariah), five sharia district development bank units (BPD), four private commercial bank units and fifteen BPRS are in the process of being established. This will bring the total to 20 commercial banks and banking units and 99 BPRS.

- Their share in terms of total assets more than quadrupled from 0.17% in December 2000 to 0.74% in December 2003; deposits more than quadrupled from 0.15% to 0.64%; and financings almost tripled from 0.40% to 1.16%. (Table 3.3; see also App. 3 Table 1)

Table 3.6: Share of Islamic to national commercial banking activities, 2000 – 2003 (in %)

Item	2000	2001	2002	2003
Assets	0.17	0.25	0.36	0.74
Deposits	0.15	0.23	0.35	0.64
Loans (or: financing)	0.40	0.57	0.80	1.16

Sources: BI 2003:127; BI 1/2004:13

Most remarkable is the **difference in performance between conventional and Islamic commercial banks**. In relative terms, (i) the Islamic banks lend more of the funds deposited, with a LDR or FDR of 97% compared to 54% of the total commercial banking sector; (ii) their gross non-performing loans (NPL) ratio is persistently lower, and the improvement of their performance faster than that of conventional banks after the financial crisis. Non-performing loans amount to 2.3% of financings outstanding, which is far below the 8.2% of the total commercial banking sector.¹⁵ NPL ratios fell as follows (see App. 3 Table 2):

- Conventional banks: from 26.8% in 2000 to 14.1% in 2001 and 8.2% in 2003;
- Islamic banks: from 13.0% in 2000 to 4.0% in 2001 and 2.3% in 2003.

However, despite the Islamic banks' better performance in terms of portfolio quality, their returns on average assets of 0.65% are less than a third of those of the total commercial banking sector at 2.12%. This difference is partially attributed to the increase in the number of Islamic banking units, which have only recently started to lend, with a major portion of their loans not yet matured. This explains their higher capital adequacy ratios (CAR) as indicated below and the overall decline in the profitability of Islamic commercial banks and banking units from 1.2% in 2001 to 0.6% in (November) 2003. (See App. 3 Table 3)¹⁶

3.5 Development of Islamic financial cooperatives

The development of Islamic banking has been paralleled by that of Islamic financial cooperatives, BMT. The first Islamic cooperative, Ridho Gusti, was established in 1990 in Bandung. After 1995 when PINBUK started promoting Islamic cooperatives under the new name BMT, their number evolved in several stages: an initial period of moderate growth up to 1995; the promotion of rapid growth by PINBUK starting in 1995, with big jumps in numbers during the crisis years 1997 and 1998; a slowing-down of growth during 2000, followed first by stagnation and then decline.¹⁷

Table 3.7: The evolution of Islamic cooperatives

No.	Phase	Period	Number of BMT
1	Initial growth	1990-1995	300
2	Rapid growth promoted by PINBUK	1996 1997 6/1998	700 1501 2470
3	Slowing-down of growth	2000	2,938
4	Stagnation and decline	2001 2003	3,037 2,856 ¹⁸

¹⁵ The NPF ratio of 2.3% comprises 1.04% sub-standard, 0.29% doubtful and 1.0% losses.

¹⁶ For further information on deposits and loans by Islamic commercial banks see App. 3 Tables 4-5.

¹⁷ Always with the proviso that available data are of poor quality.

¹⁸ Based on oral information by PINBUK.

4. Islamic rural banks (BPRS)

4.1 Conventional and Islamic rural banks (BPR and BPRS): a comparison

Conventional and Islamic rural banks evolved over a similar time span, in a predominantly Islamic country: conventional rural banks since 1989, Islamic rural banks since 1991. At which pace and with what result in a predominantly Islamic country? During the 15-year period 1989-2003, the total BPR sector had grown to 2134¹, comprising 2050 conventional BPR and 84 BPRS. The average growth rate of the conventional BPR during the 15-year period was 137 institutions per year – compared to only 6.5 BPRS p.a. during a 13-year period. **Conventional rural banks have thus grown more than twenty times faster than Islamic rural banks per year.**

During the six-year period, 1991-96, when their number had reached 71, the BPRS grew at an overall average of 12 per year. During the two years when the Asian financial crisis hit Indonesia, 1997 and 1998, their growth slowed down to less than four per year. During the following five years, 1999-2003, their net growth almost stagnated, averaging one per year: seven were newly established, two were closed at the beginning of 2004. Their total number was 84 in December 2003 (declining to 82 in February 2004). Detailed data are presented in Appendix 2.

With Rp 191.75bn in total assets (Dec. 2003), **the Islamic rural banks account for 1.5% of the regulated BPR sector.** Total assets per BPRS are on average of Rp 2.28bn or US\$ 270,100 per BPRS, compared to Rp 6.05bn or US\$ 715,300 per BPR. **With 38% of the assets of an average BPR, BPRS are thus much smaller.**

BPRS account for 1.5% of loans (financings) outstanding, but only 1.2% of deposits of the total BPR sector. Historically, the share of BPRS in total assets of the BPR sector grew from 0.75% in 1993 to a high of 2.93% in 1998, paralleled by increases in the share of loans outstanding from 0.62% in 1993 to a high of 2.88% in 1998 and in the share of deposits from 0.62% in 1993 to a high of 2.42% in 1998. The decline in the share of BPRS since 1999 is due to wide discrepancies in the growth rates of BPR and BPRS in recent years as shown in the following table. During the three-year period Dec. 2000 to Dec. 2003, **total assets of the BPR sector grew (nominally) by 173%, the assets of the BPRS by 70%** - despite the fact that the total number of BPR declined by 12% from 2419 to 2,123, while the number of BPRS increased by 5% from 80 to 84 during that period.

Table 4.1: Growth rates of BPR and BPRS over three-years, Dec. 2000-2003 (in %)

	<i>BPR sector</i>	<i>BPRS</i>
Total assets	173	70
Deposits	189	76
Loans outstanding	154	68

In terms of total numbers, BPRS account for about 4% of the BPR sector, in terms of total assets for 1.5%. The average Islamic BPR is thus **less than half the size of the average conventional BPR.** As capital shortage is one of the main reasons for the failure of many unregulated small financial institutions to transform into regulated BPR, and as most BPRS are so much smaller than conventional BPR, we may hypothesize that capital shortage is one of the causes of the slow growth of the Islamic rural banking sector.

¹ 62% of them newly established, 38% converted from existing non-banking institutions.

Table 4.2: Conventional and Islamic rural banks (BPR and BPRS), Dec. 2003 (amounts in billion Rp)

	Total BPR sector	Conventional BPR	BPRS	
			Absolute	% of total
No. of banks	2134	2050	84	3.9
Total assets	12,905.7	12,714	191.75	1.5
Total deposits	8,890	8,780	110.0	1.2
Total loans outstanding	9,180	9,041	138.6	1.5

In sum, Islamic rural banks account for 2.4% of the total Islamic commercial and rural banking sector, 1.5% of the rural banking sector, and 0.018% of the total banking sector. Their growth has lagged far behind that of conventional rural banks:

- The number of BPRS grew annually at a rate of 6.5 banks, conventional BPR at a rate of 137.
- Average assets of BPRS amount to only 38% of the assets of conventional BPR.
- During 2001-2003, total assets of the BPRS grew (nominally) by 70%, compared to a growth rate of 173% of the total BPR sector.

4.2 Regional distribution

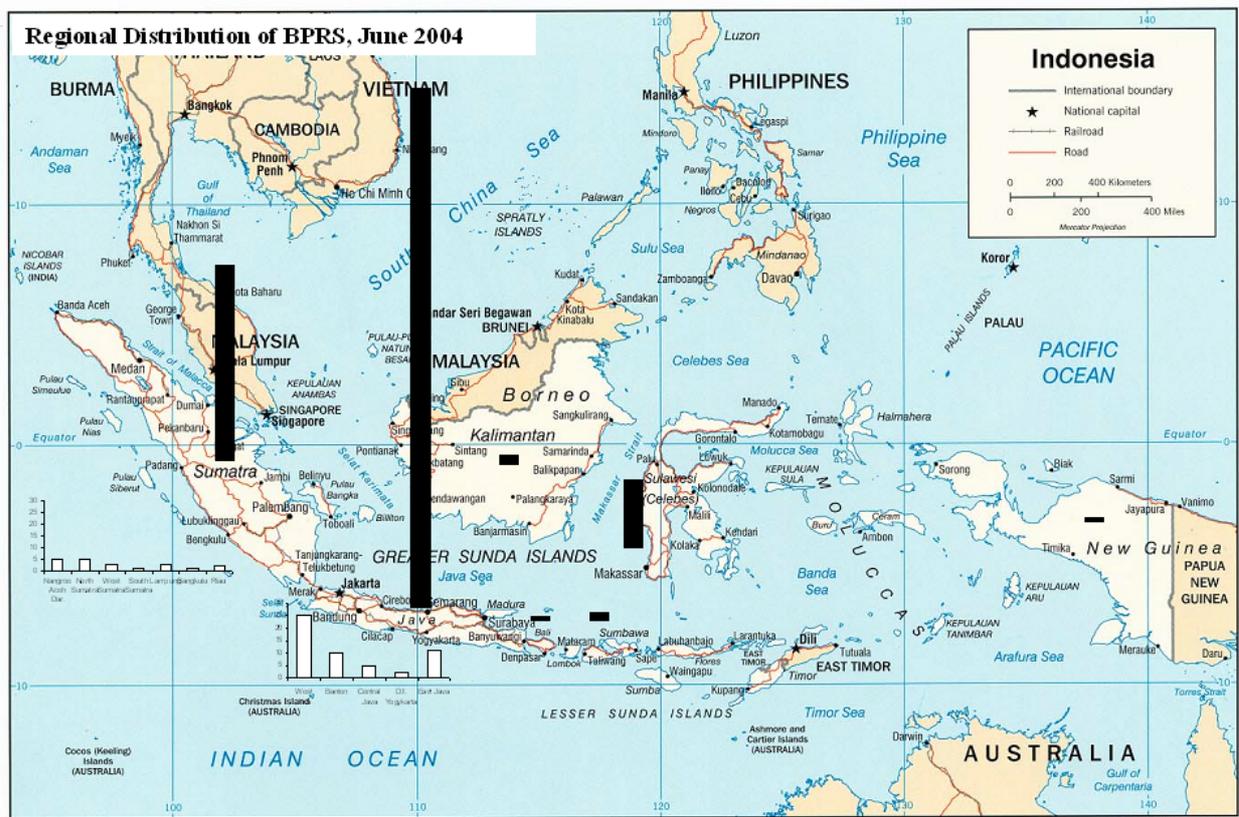
Of 90 BPRS ever licensed between 1991 and June 2004, 86 are still active. Two have been closed and another two are in the process of being closed, all four located in western Java. The majority of BPRS, 62%, are located on Java (where the majority of the population of Indonesia lives), mostly in western Java (41%), which comprises the provinces of West Java and Banten. 20 BPRS, or 23%, are spread over seven provinces on Sumatra, with the largest number, namely five each, in Aceh and North Sumatra. The other ones are spread very thinly over the remaining archipelago. (*App. 4 Table 1*) The geographical distribution by major island and province is shown in the map below. A complete list of all BPRS and their locations is given in Annex 1.

4.3 Mission, ownership and governance

The mission of Islamic rural banks in Indonesia is helping the enterprising poor, particularly small traders and microentrepreneurs. In four sample BPRS, the average percentage of clients below the official poverty line was estimated at 6%. The explicit emphasis of the Islamic MFIs on the poor is in contrast to conventional BPR which are oriented to profit-making. Two problems have resulted from the way the BPRS have defined their mission: On the demand side, many of the customers have a (mistaken) concept of low or no interest rates or profit margins in sharia banking. On the supply side, BPRS focus on the microsector instead of starting with more profitable market segments such as salary earners and small entrepreneurs. It is this difference in mission which has contributed to the slow growth of BPRS. While both are (mostly) established by wealthy local people, the owners of BPR have a commercial orientation with the objective of increasing their wealth, while the owners of BPRS have a social mission, combined with the intention to at least cover their costs.

Ownership: Most BPRS are privately owned, usually by one majority shareholder and several minority shareholders. In the five sample BPRS, there are between three and 118 owners, mostly private individuals (*App. 4 Table 2*). In some cases, Islamic foundations, companies and local government are shareholders. Some Islamic cooperatives, BMT, have initiated the establishment of a BPRS, but due to lack of capital are not shareholders. Most owners are absentee owners, living in Jakarta or a provincial capital. If there are many shareholders, their involvement in decision-making is small if not absent. In contrast, many owners of conventional BPR also act as general managers or president-directors.

Map 1:



Board of directors: Every BPRS has three boards: a sharia board which watches over Islamic principles, a management board and a supervisory board. Members of the sharia board usually come from religious organizations like the local Majelis Ulama, from mass organizations and Islamic universities. The supervisory board of commissioners (*komisaris*) comprises representatives of majority shareholders and financial experts. There are usually three members on the sharia board and three on the supervisory board. It is rare that anyone of them has a regular full-time or part-time position; most of them act perhaps one day a month or upon request. The management board usually comprises a director and a deputy director, which are both full-time employees. In the five sample BPRS, the board of directors has between seven and ten members (Table).

Management, upon the insistence of Bank Indonesia as the regulator, is usually comprised of one or two directors with banking experience. Due to the recent history of Islamic banking and an overall shortage of trained bankers, Very few BPRS managers have any experience in sbanking. Most are retirees from conventional banking, who have received some training in Islamic banking principles. This has resulted in a selection of older people frequently from state banks, lacking perhaps in drive and innovativeness as one might expect from younger people eager to experiment with fresh ideas in Islamic banking. Management is considered largely autonomous, sometimes too autonomous and uncontrolled, particularly in a situation of absentee ownership combined with management by retired state bankers experienced in enforcing bureaucratic rules rather than exploring new products and customer segments. No evidence was found of frequently emerging controversial issues between management, board and shareholders. Decision-making is by consensus *musyawarah*. Lack of management skill and dynamics are considered the only major problem.

Control and supervision: *Internal control* is by absentee commissioners whose activities are limited to receiving monthly reports and monthly or quarterly visits: either the commissioners visiting the bank; or the bank visiting the commissioners – sometimes in far-away places. Their role is generally considered not very effective - hence the considerable autonomy of management! *External auditing* by a public accountant is compulsory if assets exceed Rp 10bn; but most lack dynamic growth and remain below that limit. Asbisindo, the business association of Islamic bank, recommends voluntary external auditing, which is problematic as historical experience has shown. *Supervision* of BPRS as part of the banking system is compulsory and carried out by Bank Indonesia on an annual basis. *Accounting and reporting standard*, including the computation of standard performance ratios, are regulated and enforced by Bank Indonesia.

4.4 Delivery system

There are no statistics on the **number of branches** of BPRS. In its official reports BI lists the number of delivery units of commercial banks only. Of the five sample BPRS only one is a unit bank; the other four have been one and four branches. The average number of delivery units (including the head-office) is three. The sample BPRS have between 11 and 38 **staff members**, averaging 21.4 per BPRS and 4.3 per delivery unit. Half the staff members (49%) are loan officers, usually equipped with motorbikes. The service radius is between 20 and 50 km, averaging 38 km. (App. 4 Table 3)

Incentive scheme: Most BPRS have a system performance incentive scheme based on an annual bonus which is related to the bank's profit, but not to the performance of individual staff members. There is an on-going discussion on how to adjust staff remuneration to the profit-sharing principle of Islamic banking, with a basic salary to cover transportation and an advance, and a sharing of the profit between owners and staff according to an agreed-upon ratio. BPRS Mentari in Garut is experimenting along these lines.

4.5 Market and outreach

Market segment: The BPRS market segment covers the enterprising poor with existing enterprises, predominantly small traders. BPRS are open to all, irrespective of their religion. Outside religious organizations, there seems to be no public debate over interest rates and principles of conventional vs. Islamic banking. It appears that Islamic banking is a matter of access and effectiveness rather than religious conviction. Ultimately, Islamic banking in Indonesia will have to prove its worth in terms of outreach and quality of service.

- There does not seem to be a public awareness of Islamic economics and banking, nor any widespread demand for such services from the target group.

Depositor and borrower outreach: Figures on outreach are highly problematic as banks normally report amounts of deposits and loans outstanding, but rarely if ever the number of depositors and borrowers. BPR as well as the BRI units provide data on the number of deposit accounts and loan accounts, which must not be confused with the number of clients, as one client might hold several accounts. This is less likely with regard to loan accounts, which are thus close to the number of borrowers.

There are no overall statistics on the number of clients of BPRS. According to official statistics, total depositor outreach of the BRP sector as of 2003 is 5.5 million. The average number of depositors per BPR is 2,594² (see App. 1 Table 1). As BPRS have only 38% of

² Compared to an average depositor outreach of 7,374 per BRI unit.

the asset size of BPR, one might expect an average of less than 1,000 depositors.³ Total depositor outreach of the 84 BPRS might be estimated at 83,000⁴.

Total borrower outreach of the BPR sector as of 2003 is 2.0 million, with an average of 934 per BPR.⁵ If we assume that, as in the case of assets, the average number of borrowers of an BPRS is 38% of that of a BPR, we arrive at a figure of 355 and a total borrower outreach of all 84 BPRS of around 30,000.⁶

Composition of clients: There are no overall statistics. In our five sample BPRS, most of the clients, on average 79% per BPRS, are small traders and microentrepreneurs; 17% are wage and salary earners, 3% are farmers. The percentage of women clients varies from 0 to 45%, with an average of 28%. About 5% are estimated to be below the official poverty line. (App. 4 Table 5)

Financial products for the poor and non-poor: Under sharia there are two models of client selection: (i) clients with existing businesses and successful operations for at least two years. (ii) new entrepreneurs without preceding business experience. The vast majority of clients are those with existing business and a good track record; they can be financed through such financial products as Murabahah, Musyarakah and Mudarabah, which involve some form of profit-sharing. New clients without a track record are considered very risky and represent but a small minority; they can be financed through Qard al-Hassan, soft loans without any charge or profit-sharing. It is argued that not everyone is a born (micro-) entrepreneur; many of the poor lack the qualification to become entrepreneurs and should rather become workers in larger enterprises, which may in turn be financed through financial institutions. Consumer loans and loans for speculative investments, which could be ruinous to the borrower, are excluded from the range of permissible purposes of financing.

4.6 Total assets and sources of funds

Total assets of the BPRS, according to the consolidated balance sheet of all BPRS as of Dec. 2003 compiled by Bank Indonesia, amount to Rp 191.75bn, or an average of Rp 2.28bn (US\$ 270,000) per BPRS. At 38% the size of an average BPR and 37% the size of an average conventional BPR, BPRS are thus much smaller than conventional BPR. Total assets in our five sample BPRS range from Rp 1.40bn to Rp 12.6bn; the average is Rp 7.10bn, which is more than three times the size of the average BPRS and 17% above the size of the average BPR. (App. 4 Table 6)

The main source of funds of BPRS, according to BI's consolidated balance sheet, are deposits by clients amounting to Rp 110.0bn, which is 57.4% of total assets. Other main sources of funds are equity including reserves and profits of the current year (22.9%), bank deposits (11.5%) and borrowings (3.8%). Authorized capital amounts to Rp 51.45bn, paid-in capital to Rp 31.0bn. (App. 4 Table 7)

³ In four of our five sample BPRS, the average number of clients was nearly 4000, equal to the number of savings accounts. This unexpectedly large number of clients is related to the fact that the sample BPRS are more than three times the asset size of the average BPRS.

⁴ Basis of calculation: 38% of the average BPR.

⁵ Compared to an average borrower outreach of 766 per BRI unit.

⁶ Only one of the BPRS visited, BPRS Fisabilillah, was able to give an exact number of loan accounts, namely 163; the number of active borrowers was given as 157. Two BPRS estimated the number of borrowers at 800; BPRS Wakalumi, by far the largest in terms of assets, gave a number of 2000 borrowers. The overall average is 941, which reflects the unusually large size of the selected BPRS. (App. 4 Table 4)

4.7 Financial services

Deposits : BPRS are less successful in deposit mobilisation than BPR. The deposit volume of an average BPRS is less than one-third of the sector average (Rp 1.31bn, or US\$ 155,000, compared to Rp 4.17, US\$ 493,000).⁷ Among BPRS, deposits amount to 57.4% of total assets, among conventional BPR to 69.1% (BPR sector average: 68.9%). BPRS finance 79.4% of their loans outstanding from deposits, BPR 96.8%. In other terms, the loans-to-deposit ratio (LDR) of BPRS is 1.26, the LDR of BPR is 1.03. (App. 3 Table 8-9) We might conclude that revenue-sharing is not as attractive to depositors as a definite interest rate.

Remuneration of depositors is based on the Mudarabah principle of partnership-based revenue-sharing between depositors and the bank. The ratios varying in the sample BPRS from 30:70 to 50:50. In some banks the revenue-sharing arrangements are negotiable.⁸

Financings (loans): Total financings (loans outstanding) of 84 BPRS as of Dec. 2003 amount to Rp 1.65bn (US\$195,200) per BPRS, compared to Rp. 4.30bn (US\$ 509,000) for the whole BPR sector and Rp 4.41bn (US\$ 522,000) per conventional BPR. The share of loans outstanding in terms of total assets is virtually the same in BPRS and BPR (as well as conventional BPR), 72.3% and 71.1%, respectively. Average loans outstanding per BPR are Rp 4.3bn, per conventional BPR Rp 4.41bn and per BPRS Rp 1.65bn. The loans-to-deposits ratio is 126% in BPRS and 103% in both BPR and conventional BPR.

Table 4.3: Financings (loans outstanding) of BPRS and BPR in Rp billion and percent of total assets, Dec. 2003

	<i>BPRS</i>	<i>Conventional BPR</i>	<i>BPR sector</i>
Average loans outstanding per bank in Rp bn	1.65	4.41	4.30
Financings in % of total assets	72.3	74.5	71.1
FDR, LDR	126	103	103

The main loan product in BPRS is Murabahah, ie, a sales contract between bank and customer with a fixed profit margin for the bank. Flexible profit-sharing, which is cumbersome to calculate, is of minor importance. (App. 4 Table 11 + text)

4.8 Economic performance

No data are available on the performance of the BPRS sector as a whole. There are conflicting views on how they compare to conventional BPR. Some argue that the emphasis on financing profitable activities only and the stricter lending terms should result in higher

⁷ Total deposits by clients in 84 BPRS amount to Rp 110.0bn, comprising Rp 58.57bn (53%) in passbook savings, which are voluntary and withdrawable at any time, and Rp 51.42bn (47%) in time deposits. In the five sample BPRS, average deposits per bank amount to Rp 4.0bn or Rp 1.0m per depositor. Several of the sample BPRS offer doorstep collection services.

⁸ As an example, BPRS Artha Fisabilillah offers three *mudharaba* savings products, all voluntary and withdrawable at any time, which differ only by target group, one remuneration-free savings product for religious purposes and a fixed deposit product with different maturities. Its loan officers offer doorstep collection services, serving about 200 clients a day. In BPRS Harum Hikmahnuagraha, the ratios for savings vary from 7% to 11% by client. Returns are calculated on a monthly basis. Annual averages vary from 7% to 12%; the unweighted mean is 8.3%. The revenue-sharing arrangements in the case of time deposits vary between the banks from 40:60 to 70:30. They also vary by maturity, in the case of BPRS Wakalumi from 56:44 to 66:34; the figures for the other four BPRS are estimated averages. Returns on time deposits vary between the five BPRS from 10% to 18% p.a.; variations by maturity in BPRS Wakalumi are from 11.35% to 13.37% during 2003. Current accounts are usually remuneration-free. An exception is BPRS Harum Hikmahnuagraha, which pays a voluntary bonus. Some banks, like BPRS Artha Fisabilillah offer a savings product for religious purposes which carries no remuneration. (App. 4 Table 10)

profits, as is in fact the case among Islamic commercial banks. But others point to the relatively small size of the average BPRS compared to conventional BPR, and their restriction to lower market segments. Our sample BPRS are not representative, as they are much larger than the average BPRS. In four of the five sample BPRS, non-performing loan (NPL) ratios are between 0 and 11%, averaging (unweighted) 4.6%. Returns on average assets (ROAA) vary from 2.0% to 5%, averaging 3.2%. All of the five sample BPRS have reported current year profits. (App. 4 Table 12) By comparison, the BRI units, as benchmark MFIs in Indonesia, have an NPL of 2.5% and a ROAA of 5.7%.

Compared to BMI, the first Islamic commercial bank in Indonesia, BPRS pay slightly more on deposits but charge three to four times as much on financings, as BPRS loans are far smaller in size and thus more costly, and BPRS on the whole are less efficient.

Two of the five case studies are presented below, the smallest and the largest of the five BPRS.

Box 1: Two sample BPRS

BPRS Artha Fisabilillah in Cianjur, the smallest of the five sample BPRS, was established in 1994 by 9 shareholders. By 1997, as a result of lack of management experience, it was technically bankrupt and was restructured. The new management was not very dynamic and was replaced in 2001 by a retired BRI credit officer. The bank, located next to a local market, has 1150 savers and 163 borrowers. With a staff of eleven, six of them loan officers, it offers doorstep collection services to about 200 clients a day. It also offers deposit services to school children and institutions. Total assets are Rp 1.40bn, deposits Rp 0.62bn and financings outstanding Rp 1.21bn. Its overall performance is not yet satisfactory. Its main problem is lack of funds, due to a shortage of deposits and capital from the owners. The bank is struggling with loan recovery and has improved considerably in 2003. Its NPF ratios in 2001, 2002 and 2003 were 9.6%, 190.8% and 4.5%, respectively; its loan loss ratios were 8.9%, 18.7% and 6.25%. Yet the bank has been in the black for the past three years, with ROAs of 2.3%, 1.7% and 2.4% and ROEs of 7%, 4.3% and 8.75%, respectively. Its main future strategy to improve efficiency is staff upgrading through training. (App. 4 Table 13)

BPRS Wakalumi in Ciputat, the biggest of the five sample BPRS, was established in 1990 by a foundation (Yayasan Wakalumi) as a conventional BPR and converted for religious reasons into a BPRS in 1994. It has 118 shareholders, among them BMI (19%, down from 49%), the former Minister of Cooperatives (23.5%), a Citybank manager (26%), the founding foundation Yaysan Wakalumi (5.6%) and over a hundred individuals, mostly Muslims working at Citybank. The bank seems to have a successful staff promotion strategy: the president director, with a B.A. in agriculture, has been with the bank since 1994, learning on the job and promoted up the ranks; the director, a woman with a diploma in accounting, has been an employee since 1997 and was promoted to director in 2003. The bank has grown rapidly and now has five branches and a staff of 38, 13 among them loan officers. Its 2000 borrowers are mostly small traders on traditional markets, to whom it sells its financings as Islamic products. It has four financing products, with Murabahah the dominant one. Through eight savings products and four term deposit products, it has attracted 5000 savers. With ROAAs in 2001-2003 of 4.1%, 3.65% and 3.35% and ROAEs of 20.3%, 21.05% and 24.1%, respectively, it is highly profitable: apparently a showpiece that could serve as an exposure and apprenticeship training site for other banks. (App. 4 Table 14)

4.9 Affiliations and support

ASBISINDO, Asosiasi Bank Syariah Indonesia,⁹ was established in 1992 as an association of rural Islamic banks (BPRS); since 2002 its coverage also includes Islamic commercial banks. There are no other associations of Islamic banking institutions in Indonesia. Its objective is the development of Islamic banking in Indonesia through human resource development, technical assistance, operational standardization and financial product development, facilitation of vertical and horizontal communication among Islamic financial institutions, advocacy and participation in policy dialogue. The two Islamic commercial banks,

⁹ Formerly: Asosiasi Bank Islam Indonesia

7 out of 9 Syariah units of commercial banks and 82 BPRS are members of Asbisindo. Its main activity is the training of management and staff of Islamic commercial banks and rural banks. In 2003 Asbisindo offered five national courses with approximately 100 participants each, plus 4-7 courses with 25-30 participants per regional office. Asbisindo also issues a quarterly Bulletin and is in the process of preparing a directory of Islamic banking institutions.

Asbisindo comprises a head office in Jakarta, housed by Bank Indonesia, and 10 regional offices. It is run by a board and an executive secretary (Basril). The head office has a total staff of three; the regional offices, with training as their main function, have a staff of one or two each. The board has 14 members from Islamic commercial and rural banks, chaired by Wahyu Dwi Agung who is also an assistant director of BMI and a commissioner of three BPRS. Basic costs are funded from membership fees, Rp 5m per commercial bank or unit and Rp 1.2m per BPRS per year. The training costs are borne by the participants. Through special projects, Bank Indonesia supports workshops and seminars. There are no international donors; Asbisindo does not receive any technical assistance from any source. Asbisindo maintains close relationships with Bank Indonesia, the national Syariah board Majelis Ulama Indonesia/Dewan Syariah Nasional (MUI/DSN), the national legislative council of Indonesia (DPR) and various business associations.

Asbisindo's future plans are to become a strong association to provide a full range of services to all Islamic banking institutions as its members; and to contribute substantially to their growth and strength. Among its future services are a certified Islamic bankers training program recognized and approved by Bank Indonesia. In cooperation with the Islamic Banking Directorate of Bank Indonesia, it is also working on a draft Islamic financial institutions law. Asbisindo needs donor assistance in the preparation of a certified Islamic bankers training program and of an Islamic banking law.

PNM refinances BPR and BPRS and other conventional and Islamic financial institutions and supports their capacity development (see chapter 6.8).

Majlis Ulama is an organization of Islamic scholars which maintains relations with many Islamic banking institutions. It is the initiator of Islamic banking in Indonesia and a shareholder of BMI, the first Islamic commercial bank. Its head office is in Jakarta. It also maintains offices in provinces and districts, where it plays both a socioeconomic and a political role.

4.10 Perceptions of Islamic banking by the public

In 2000, after ten years of Islamic banking development in Indonesia, Bank Indonesia realized that "the Syariah Banks in Indonesia do not grow fastly in terms of their networking as well as size of production compared to the conventional banks... (and that) their development is not based on infant industries argument which needs protection and special rights." (BI & RCDS 2000:2) Arguing that the development of Syariah Banks not only depends on the legal framework and the moral values applied in the banks' operations, but also on "society's demand for their products and services", it commissioned interview studies in western and central Java to find out whether such a demand exists; or whether the lack of market demand for specifically Islamic financial services might be one of the explanations for their slow growth. The results are presented in BI & RCDS (2000) and Ratnawati et al. (2000) of Diponegoro University in Semarang.

The results of the study in central Java were not very revealing and ultimately inconclusive.¹⁰ It was found that there were three groups of respondents: those who wanted to deal with Syariah Banks, those did not, and those who were neutral; that age and education had an influence on attitudes to Syariah banks; and that some regions (Semarang, Pekalongan,

¹⁰ Data analysis is based on logistic regression modeling (logit); the presentation is incomprehensible.

Kendal, Surakarta and Yogyakarta) were more receptive to Islamic banking than others. It was recommended to "intensify socialization through interpersonal media, electronic media, as well as printed media." (BI & RCDS 2000: 21-23)

In contrast, the study in West Java arrived at unequivocal conclusions:

"In general, the performance of syaria bank, in the present time, is far behind compared to its older brother of conventional bank:

1. People prefer a bank system for its better service in general, facilities provided, credibility, and bank status, while on the other hand people tend to avoid syaria bank for their... limited services and facilities, faint status, and low credibility.
2. People who are open to information and have extensive access to it tend to discontinue (as customer) in being a syaria bank customer or refuse (not yet as customer) to adopt such a system. This shows that syaria bank performance is considered inferior to the conventional banks". (Ratnawati 2000:18)

These conclusions concur with our own observations that there is little popular demand for Islamic banking services; and that their choice is more (though not exclusively) a matter of proximity and convenience than religion. They also concur with the anecdotal observations of the ADB (2003) team, which included a number of BMT in their studies of MFIs and in one of them, BMT Al-Iman in Pandeglang District in Banten Province, interviewed three (of 1,066) members, who all gave convenience as the main reason for their patronage.

Box 2: Reasons for their patronage among customers of BMT Al-Imam, Pandeglang District

"Three clients of the BMT were interviewed: The first was a woman, a primary school teacher, who had come to make a small deposit into her savings account which had reached a balance of Rp. 1.6 million. She is not a member of the BMT as she has not made the initial deposit required of members. The main reasons for her patronage of this BMT was its convenient location to her home and the relaxed environment with seldom, if ever, a need to form a queue and wait in line.

The second client interviewed was a man, a member of the BMT who has two savings accounts. One is a normal current account with a balance of Rp. 100,000 and the other is the savings account designed to meet the annual needs of Moslems during the Idul Fitri celebration in December when he expects to withdraw the full amount which by that time will have reached Rp. 300,000. This client also cited convenience and flexibility as a reason for becoming a member of the BMT.

The third client interviewed was a man, a well-off farmer who owns 1.2 ha for the purpose of paddy and vegetable production. This man has four savings accounts with the BMT, the combined total of which was Rp. 6.38 million. The reasons given for patronage of the BMT was cited as the quick and convenient services provided including personalized service whereby on occasion the staff deliver the service to his door."

(ADB 2003, Regional Profile Section VII, Banten (Pandeglang District)

5. Islamic cooperatives (BMT, BTM)

5.1 Conventional and Islamic cooperatives: a comparison

Indonesia has a differentiated sector of cooperatives, which has been historically dominated by the heavily subsidized KUD system: *Koperasi Unit Desa*, multi-purpose cooperatives at sub-district level with units at village level. By law all co-operatives had to be integrated into the KUD system. As government intervention in management and resource allocation stifled any spirit of autonomy and self-help, privately organized credit unions and large numbers of self-help groups resisted being incorporated, including the self-help groups under Bank Indonesia's *Program Linking Banks and Self-Help Groups (PHBK)*. In recent years, ie, since the downfall of the Suharto regime, the cooperative sector has seen some liberalization, but is still far from self-organization and autonomy. In fact, the very existence of a Ministry of Cooperatives, with unclear and perhaps counterproductive functions, stands in the way. In the framework of the new decentralization law, cooperatives are now being registered autonomously in the districts and provinces, which is likely to make the task of regulation and supervision more difficult. The lack of authority of the Ministry of Cooperatives is reflected in the no-reply rate of 73% among KSP/USK reported by the Ministry as of 13 April 2004. There is no national organization of financial cooperatives – as an alternative to a Ministry of Cooperatives - which could take over the apex functions of liquidity exchange, regulation and supervision.

Financial cooperatives are part of the cooperative sector and have similarly suffered from state interference and subsidization. As financial institutions, they should be prudentially regulated and properly supervised by a financial authority, but they are not. The Ministry of Cooperatives has been unable, Bank Indonesia and the Ministry of Finance unwilling to regulate and supervise them. The draft microfinance (LKM) law of 2001 seemed to prepare the way for incorporation into the regulated financial sector, but has been put on ice; its future is uncertain. An alternative, which has evolved¹ in developed countries like Germany¹ is a delegated system of regulation and supervision in the hands of national and regional associations of financial cooperatives (turned into local cooperative banks) with their apex auditing federations, placed under the banking law and under the ultimate authority of a bank superintendency.

As there is no reliable reporting system, the figures on financial cooperatives given below are only rough approximations; they are incomplete, based on different years and frequently carried forward unchanged over several years. While the Ministry of Cooperatives, now reorganized as the Ministry of Cooperatives and Small Enterprises, has been in charge of registration, regulation and supervision, it has only poorly fulfilled any of these functions. In actual fact, there is only limited and selective registration, inadequate regulation and virtually no effective supervision.

The more than 40,000 financial cooperatives constitute 76% of all formal and semiformal MFIs listed in App. 1 Table 1. Most of them are relatively small in outreach, comprising 34.2% of all loan accounts and 23.5% of all deposit accounts. In terms of volume, they account for 18.1% of all MFI loans outstanding and 4.8% of deposits. The picture changes if we leave out the units of the BRI Microbanking Division, the giant on the Indonesian microfinance scene. Without the BRI units, financial cooperatives constitute 82.0% of all MFIs, 37.8% of loan accounts and 64.5% of deposit accounts; in terms of volume, they account for 38.9% of loans outstanding and 23.8% of deposit balances. Compared to rural banks (BPR) as of Dec 2003, there are 19 times as many financial cooperatives with six times as many borrowers and twice as many depositors, but only half the volume of loans outstanding and less than one-fifth of their deposit volume. (App. 5 Table 1)

¹ The Netherlands initially followed the same evolutionary path, but eventually centralized cooperative banking in a single institution, Rabobank, converting the former independent financial cooperatives and cooperative banks into branches.

The largest number of financial cooperatives are the savings and credit units (USP) of the state-run multipurpose cooperatives, KUD, accounting for 87% of all units, 76% of loans outstanding and 70% of deposits. The Savings & Credit Cooperatives, KSP, are part of the same KUD system but are, in contrast to USP, organizationally and financially independent of the KUD. Together, the reported number of USP and KSP as of ~2000 is 36,341, which 97% of all listed conventional cooperatives and 90% of all cooperatives in Table 1.

According to statistics of the Ministry of Cooperatives, the total number of KSP/USP has grown to 40,639 as of December 2003, which includes those credit unions and BMT which decided to register as cooperatives; they also include cooperatives which are inactive and have failed to report. The Ministry has financial information on 36,376 KSP/USP as of December 2003, a decrease of 0.4% in number and 8.8% in total assets as shown in the following table. The statistics are broken down by province, but not by Islamic vs. non-Islamic type. (App. 5 Table 2)

The KSP and USP are on principle registered with the Ministry of Cooperatives and are subject to a regulatory framework, with minimum capital requirements to become a cooperative, a soundness rating system (based on that for banks) and a loan classification system. However, deficiencies include the absence of legal lending limits, requirements for loan-loss provisioning (left up to individual cooperatives) and sanctions. There is no effective supervision; and whatever regulation exists is not enforced after registration. Also, there is no deposit protection system, and there are no associations of KSP/USP.

The 1,071 credit unions (Koperasi Kredit) are privately organized and supervised by INKOPDIT, their national apex, which has rated 90% of them as sound. They are part of the world credit union movement under WOCCU. A small cooperative movement, Swamitra, has been organized by the state cooperative bank, BUKOPIN.

The Islamic cooperatives, BMT, are a recent development, with rapid growth during the first part of the 1990s. Its 2,938 units (as of 2000) constitute 7.2% of all financial cooperatives, 2.8% of deposits and 1.1% of loans outstanding (ADB (2003)). The majority of them are registered with PINBUK, not with the Ministry of Cooperatives, which has no information on how many of them are registered as cooperatives. BI estimates the number of registered BMT at 500 out of a total of 3000.

Table 5.1: Financial cooperatives: Conventional and Islamic, ~2000*

	<i>Units</i>	<i>Deposit accounts in '000</i>	<i>Deposit volume in Rp bn</i>	<i>Loan accounts in '000</i>	<i>Loans outstanding in Rp bn</i>
Conventional cooperatives	37,589	11,043	1,613	11,020	4,736
Unit Simpan Pinjam (USP)	35,218	10,141	1,659	10,141	3,629
Sav&Cr Coops (KSP)	1,123	551	1,157	551	708
Credit Unions (CU)	1,071	296	151	296	272
Swamitra/BUKOPIN	177	55	249	32	127
Islamic cooperatives, BMT	2,938	400	46	73	51**
Total	40,527	11,443	1,659	11,093	4,787

*Adapted from App. 1 Table 1. Estimate of number of deposit accounts based on Timberg 2003:7

**Timberg (2003:7) reports outstandings of Rp 187bn by 2,470 BMT as of June 1998.

Not separately listed in the above statistics are 1,500, mostly rural, Kopontren: financial cooperatives connected with Islamic colleges, Pesantren, and registered with the Ministry of Cooperatives. Most of them do not follow Islamic banking practices, and their leadership reportedly does not want to be associated solely with Islamic finance. Only a small number, perhaps 10-20%, have shifted to Islamic banking. (Timberg 2003:7)

5.2 Sample BMT: origin and history

There is a paucity of information on Islamic cooperatives. In the following we therefore rely heavily on the four sample BMT visited, fully aware of the pitfalls of an extremely small and unsystematic sample.² All four were selected by ASBISINDO and, for reasons of time constraints, all located in western Java, three in the province of West Java and one in Jakarta (App. 5 Table 3):

- BMT At-Taqwa, Kemanggisan, West-Jakarta
- BMT Ibaadurrahman, Sukabumi
- BMT Latanza, Garut
- BMT Wira Mandiri, Tasikmalaya.

BMT At-Taqwa was first established in 1994 as a pre-cooperative under the name of Baitul Maal Wat-Tamwil (BMT) At-Tawqa by four members as representatives of the Mosque At-Tawqa. The initiative had been taken by the management of the Mosque At-Taqwa and an employee of BMI in the neighborhood. The initiative was part of PINBUK's program of establishing Islamic cooperatives, which also provided training. The start-up capital of Rp 23m was provided by Yayasan Taqwa Bakhti which manages the Mosque, comprising Rs 5m in fresh money and 18m in equipment. In 2000 it registered as a cooperative under the MoC, with 1500 members. Today, in early 2004, it has 4000 members.

BMT Ibaadurrahman was established in 1992 as a BMT unit in a multi-purpose cooperative of a Pesantren. In response to popular demand, it started with a membership of 1500 and now has 3000 members. It is registered as a savings and credit cooperative unit, USP, within a multi-purpose cooperative since 1992.

BMT Latanza was newly established in 1996 as a self-help group (KSM) through PHBK, Bank Indonesia's *Program Linking Banks and Self-Help Groups*. It was initiated by young people in town, inspired by PINBUK, which also suggested the cooperation with PHBK. It comprises 800 members organized in 80 SHGs. 20 of the SHGs are active borrowers; 60 are savings groups only. In 2000 it registered as a cooperative, KSP, with the MoC.

BMT Wira Mandiri was established in 1997 as a self-help group (KSM). Later in the year it changed its status to BMT and was registered as a cooperative of employees of Yayasan Wira Mandiri (YWM), a foundation. In 1999 it was registered as a Koperasi BMT (KBMT) with a broader membership for the purpose of savings and credit activities. Its founding organization, YWM, which had been established for the promoting Islamic education, is now dormant, but living on in the BMT.

5.3 Regional distribution

PINBUK has provided a table and map of the regional distribution of BMT for Dec. 2001. The data for 2003 are based on changes manually inserted during our visit and need to be verified. According to this information, the total number of BMT has declined by 6.0%, from 3037 reported as of December 2001 to 2856 as of December 2003 – after exceptional growth rates during the crisis years of 1997/98 and a slow-down in growth during 1999-2001. ADB 2003 (Suppl. App. C, p. 21) reports that the number of members and customers of BMT has been stagnating or declining in recent years.

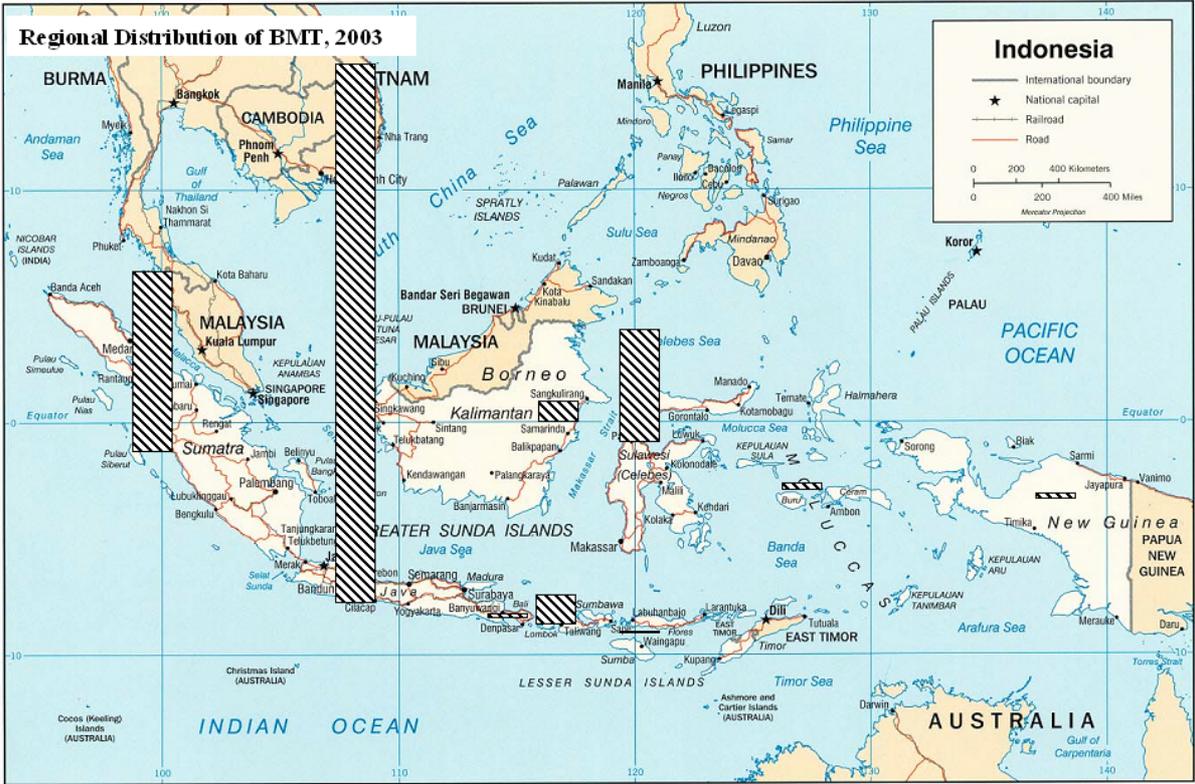
The majority of BMT, namely 65% in 2001 and 60% in 2003, like BPRS, are located on Java where they are spread far more equally than BPRS over the western, central and eastern parts. Big declines in numbers are reported for Jakarta West Java and East Java, while

² An additional case study of a BMT in Metro Lampung has been reported by ADB 2003 (Suppl. App. C, p. 21), with 53 members, 700 borrowers (average loan size Rp1.75 million) and 1800 depositors.

numbers in Central Java und D.I. Yogyakarta have increased (*provided the numbers for 2003 are correct!*). On Sumatra, their share has increased from 16% to 20%, with big jumps in North Sumatra and Riau. The share of BMT of the other parts has changed little between 2001 and 2003. Compared to the registered KSP/USP, 40,639 in number, BMT are somewhat over-represented on Java, Sulawesi, Sumatra and West Nusa Tenggara and under-represented on Kalimantan and the smaller islands. (App. 5 Table 4)

Of the 3037 registered BMT as of 2001, 2025, or 67%, are reported by PINBUK as reporting. For 2003 PINBUK has published a directory of 1257 BMT, containing name and address, phone number, and name of manager. This may be taken as another indicator that only around one-third of the BMT are active.

Map 2: Geographical distribution of BMT, 2003



5.4 Mission, legal status and governance

Mission: The BMT in our sample see it as their mission to help the enterprising poor in the vicinity and to empower them economically. Their particular target market are very small microentrepreneurs including itinerant traders and food vendors (*kaki-lima*). ADB 2003 (Suppl. App. C, p. 21) reports that the majority of customers of BMT are urban-based and provide services to both poor and non-poor households. The size of shares varies widely. In BMT At-Tawqa, with 4000 members, a share is Rp 10,000, little more than US\$1; in a BMT in Metro Lampung visited by ADB 2003, with only 57 owner-members but 1800 customers, the size of share is Rp. one million (US\$118).

Legal status: According to Bank Indonesia, only about 500 of 3000 BMT are registered as financial cooperatives (KSP) with the MoC. All others are regarded as pre-cooperatives. With reference to the draft MFI law of 2001, BMT are considered by PINDUK as sharia MFIs (*Lembaga Keuangan Mikro Syariah, LKM-S*), which may be considered as semi-formal institutions: recognized but not regulated. All four sample BMT in our study are registered with the MoC.

Ownership: As cooperatives, they are owned by their members. BMT At-Tawqa and BMT Ibaadurrahman stated that they have 4000 and 2500 member-owners, respectively. But many BMT make a distinction between members with voting rights and partnership members without. Eg, BMT Wira Mandiri has 45 voting members and 2000 partnership members. In the case of BMT Latanza, the owners are 80 SHGs with a total of 800 members.

Board and management: Board size and composition of BMT are not standardized. The four sample BMT are overseen by boards comprising between three and 14 members, with an average of seven. They have between one and three managers.³

Internal control is generally in the hands of a supervisory board, which either meets monthly or is contacted as need arises.

External auditing and supervision vary widely. About 500 out of 3000 BMT are estimated to be registered as cooperatives with the MoC. These are required to send annual reports, formerly to the MoC as the official supervisor, now, under decentralization, to their respective provincial and district cooperative authority (Dinas Koperasi). Their function is effectively limited to registration and the receipt of annual reports. There are no auditing requirements; there is no effective supervision and no enforcement of any norms; and to our knowledge no official closing of non-functioning cooperatives.

BMTs are expected to provide monthly reports to their regional PINBUK but only about 50% comply, the remaining ones being largely inactive; many report late, and the quality of reporting is variable. Furthermore, PINBUK has no formal supervisory powers. There is no performance measure used to assess the institutional quality of each BMT and there is a high failure rate among BMTs because of weak management (ADB 2003, Suppl. App. C, p. 21). PINBUK states that it used to employ 10 supervisors, but these left when funding ceased. INKOPSYAH regularly receives monthly reports from its members (as a prerequisite for funding from outside sources). Reporting, though not yet standardized, consists of

³ BMT At-Taqwa, the largest cooperative, also has the largest board, comprising a sharia board of four, a supervisory (*komisaris*) board of five, a law and management board of four, and an internal control board of one, who meet monthly. BMT Ibaadurrahman has a board of supervision of three members only. BMT Latanza has a management board of three, a sharia board of three and a supervisory board of two. BMT Wira Mandiri has a management board of 1 and a supervisory board of three. Two of the BMT have one, and two have three managers. Management appears to be strongest in BMT At-Taqwa, with a general manager, a manager of operations and a marketing manager; and weakest in BMT Ibaadurrahman, where the manager of the multipurpose cooperative and the BMT unit are identical.

financial statements. There are no resources for on-site visits. Regional PUSKOP visit members only when invited to do so. MoC officials may attend the annual general meeting on invitation from the BMT. In general, enforcement, supervisory arrangements, information and reporting are ineffective. One of the exceptions is the cooperative authority of Central Java.⁴

5.5 Delivery system, market and outreach

No statistical information on staffing of BMT is available. In the four sample BMT, the average number of staff is close to four, more than half of them loan officers or collectors. The average service radius is about 14 km. (App. 5 Table 5)

Information on total membership and customers of BMT is not available. The vast majority of BMT clients are small traders, many of them itinerant, and some other types of microentrepreneurs, mostly in urban and peri-urban areas. Of the four sample BMT, only Wira Mandiri includes salary earners and farmers; approximately 40% of the clients are women; 45% are estimated to be below the poverty line. (App. 5 Table 6)

Saver outreach: There is no information on the total number of savers or deposit accounts of BMT. All members and clients of a BMT have a deposit account; the total number of clients usually equals the number of savers or savings accounts, from 800 to 4000 in the four sample BMT, 2325 on average. There is no information on the number of active savers. As the average asset size of the BMT sector is one-quarter of the size of our four sample BMT, it might be a reasonable estimate that the average number of depositors per BMT in the sector is around 580. In this case, total saver & borrower outreach would be 1.66 million; however, if we assume that perhaps only one-third of the listed BMT are active, the actual saver & client outreach may only be 550,000 (or less).

Borrower outreach of the BMT sector according to Table 1 in App. 1 is 73,000, or 25 per BMT, a highly questionable figure. In the four sample BMT, the number of borrowers ranges from 200 and 500 per BMT; the average (mean) is 327 (App. 5 Table 7). As the average asset size of the BMT sector is one-quarter of the size of our four sample BMT, it might be a reasonable estimate that the average number of borrowers per BMT in the total sector is around 80, which would be over three times the size derived from Table 1. Total borrower outreach would then be around 230,000. However, if we apply the same logic as above and assume that only one-third of the BMT are active, actual borrower outreach would be brought down to 76,000 (as of 2003), which is close to the figure reported in Table. 1.

5.6 Total assets and sources of funds

In the absence of compulsory registration and reporting, there is no consolidated balance sheet. For 2001 PINBUK has provided a classification of BMT by total asset category. The largest BMT, 2.1% of the total number, had assets above Rp 1 billion (US\$ 97,500⁵); 7.3% had assets between Rp 500 million and Rp 1 billion. The smallest BMT, 9.5% of the total number, had assets below Rp 50 million (US\$ 4,900); and 41.5% had assets between Rp 50 million and 250 million. 40% were in middle category of Rp 250-500 million (US\$24,400-48,800). The median was at Rp 250 million. (App. 5 Table 8)

⁴ BMT At-Taqwa, the largest of the four BMT, states that auditing and supervision are non-existent; they neither report to MoC nor PINBUK. In contrast, BMT Ibaadurrahman reports every one or two months to its local cooperative authority, from which it has received recommendations and accountancy training; it was last audited in 2002. It also sends monthly reports to BMM, but has not received any reactions. In preparation of refinancing by BMM in the amount of Rp 25, it is now being audited by BMM. BMT Latenza is not being supervised. BMT Wira Mandiri is being supervised by PINBUK and BMM, but has never been audited.

⁵ Average rate of exchange for 2001: Rp 10,255 to the US\$.

In terms of total assets, all four sample BMT are above the median of Rp 250m; the largest, with total assets of Rp 2.2bn, falls into the upper category. Mean total assets are close to Rp 1 bn, which is almost four times the median and almost six times the mean size of a registered cooperative, KSP/USP.

Mean loans outstanding in our four sample BMT are Rp 742mn, mean deposit balances Rp 717.5mn. Deposits are thus the main source of funds, followed by capital. In BMT At-Taqwa, the largest BMT, deposits exceed loans outstanding; in BMT Ibaadurrahman and BMT Wira Mandiri, they almost reach the loan volume and, together with capital, exceed the loan volume. Only one of the four, BMT Latanza, relies heavily on borrowings (to the tune of 34% of loans outstanding). The mean loan-to-deposit ratio is 103%. (App. 5 Table 9)

5.7 Financial services

The question about *the difference between Islamic and comparable non-Islamic institutions* evoked little response, except in BMT Ibaadurrahman which claims that profit-sharing is more in the interest of the customers than interest-taking; that average profits are higher for both BMT and customers because of higher transparency; and that customer relations are stronger because of specific suggestions how to improve the business; in one case this led reportedly to an increase in assets from Rp 3m to Rp 41m.

Deposits: No statistics on the overall deposit balances of the BMT sector are available. Deposits in the four sample BMT range from Rp 199mn to Rp 1,958mn; the average is Rp 717.5mn. Deposit products are mainly based on mudarabah, ie, revenue-sharing arrangements between clients and BMT. They vary in the case of savings accounts vary from 25:75 to 40:60, averaging 34:66; in the case of time deposits, depending on maturity, from 35:65 to 45:55, averaging 42:58. Average returns p.a. are approximately 8.8% in the case of savings and 13.6% in the case of time deposits: slightly higher than the returns in BPRS of 8.3% and 13%, respectively. Two of the sample BMT offer current accounts, which are not remunerated. (App. 5 Table 10)

Financings (lending): No statistics on the overall portfolio of the BMT sector are available. Financings outstanding in the four sample BMT range from Rp 217mn to Rp 1,819mn; the average is Rp 742mn, or Rp 2.3mn per borrower (compared to Rp 5.4mn per borrower in the five sample BPRS). The average FDR is 103%, the same as in the five sample BPRS.

In contrast to the five sample BPRS where Murabahah (a sales contract between bank and customer with a mutually agreed-upon profit margin for the bank) is by far the most important loan product, accounting for 86% unweighted, the loan portfolio of the BMT is more balanced: Murabahah financings account for 61.5% unweighted of the loan products and is still the top product; but Mudarabahh, the profit-sharing product, accounts for 32% and Qard Al-Hassan, the interest-free/profit-sharing-free product for poor start-up borrowers, accounts for 3.5%. Requiring collateral is standard, comprising the title of a house, land, a car or motorbike, savings, or personal guarantees. Most of the loan products are tied to savings approximately 5% of the loan size) as part of collateral. The four BMT offer no other financial services and have no other business. (App. 5 Table 11-12)

5.8 Economic performance

In the absence of effective regulation and supervision, the performance of BMT is quite uneven. Among both the registered and unregistered BMT, an unknown number of them is dormant. ADB (2003, Suppl. App. C, p. 21) found that in Lombok/NTB, an island known for the strength of its SHGs and cooperatives, only 30 out of 93 BMTs are viable. In 2001, only 67% of the registered BMT were listed by PINBUK as reporting. PINBUK estimates that perhaps 900-1000 BMT are financially viable. PNM, with a mandate of strengthening BMT

and other MFIs, has identified about 500 BMT, or less than one-fifth of the total number, as functioning and worth strengthening.

No data are available on the performance of the BMT sector as a whole. The four sample BMT are very large and not representative for the sector. NPL ratios vary widely, from 1.4% to 30%, but are mostly estimates. All four BMT show positive returns on year-end assets, with ROAs ranging from 0.16% to 2.7%; but these figures are not reliable as sizeable bad debts may not have been written off. (App. 5 Table 13-14)

Box 3: Some findings on BMT in ADB's rural microfinance study, 2003

In three regional studies of MFIs by the ADB team (2003), the BRI units came out first as sustainable institutions with wide outreach and excellent performance; in two, the BMTs came out as complete failures, while in the third the BMT, after restructuring and after considerable capital injections, showed promise. BPRS were not found in the sample.

In NTB, ADB studied five MFIs. It found that "the BRI Unit in Selong selects their client prudently from low income and well off people... In terms of viability, BRI Unit is the best with 97% loan repayment, making profit 187 million and has an LDR of 0.72. The second is Credit Union Karya Terpadu... The remaining three are not viable... and the worst is BMT Ar Rayada. (ADB 2003, Suppl. App. I)

In Donggala District, Central Sulawesi, of five MFIs studied "only BRI shows a good performance with a loan repayment of 99.1 percent and a loan to deposit ratio of 0.75... The BMT Al Amin Palu has completely failed to show an at least sufficient performance with a Loan Repayment of 5 percent. There was no loan repayment data available on cooperatives." (ADB 2003, Suppl. App. IV)

In North Lampung District, Lampung, BRI Unit Kotabumi came again out first; but BMT *Fajar* was found "potentially sustainable." It was "established in 1996 as a group managed by 5 members named *Kelompok Swadaya Masyarakat (KSM)*. By 1997 the membership had grown to 31 persons and became a cooperative. The capital originated from share savings of Rp50,000 per member. In 2002 there was a restructuring of the management and only 53 members remain. The capital structure was also amended to Rp1 million for share saving and Rp5,000 contractual savings for each member per month. Besides capital from members, this BMT has twice received loans from PNM, Rp75 million and then Rp260 million. The funds have been on-lent to 700 members. There are 1,800 total savings accounts. BMT "*Fajar*" is potentially sustainable as total borrowers already reach 700 and there are 1,800 saving accounts among a population of 135,000 people in the 5 sub-districts in its operational area. NPL is 9 percent and efforts are continuing for a further reduction." (ADB 2003, Suppl. App. V)

5.9 Affiliations and support

PINBUK: The most important promoter of Islamic cooperatives is PINBUK, the Centre for Micro Enterprise Incubation, Pusat Inkubasi Bisnis Usaha Kecil, established in 1995 by Yayasan Inkubasi Bisnis Usaha Kecil (YINBUK), a foundation, as its operational arm. PINBUK has no legal status of its own, but is operationally autonomous. It acts as a facilitator of the establishment and licensing of new BMT, which usually receive first a certificate from PINBUK as a pre-cooperative (prakoperasi) or self-help group (kelompok swadaya masyarakat), before registering with the MoC (which most do not do). PINBUK provides basic, intermediate and advanced training, plus training of trainers. It offers a wide range of training modules. The seminars are organized by PINBUK with trainers certified as Master of Training with support from government, Colleges/Universities and NGOs (MERCICORP). Additionally Pinbuk has published manuals for the establishment of BMTs; regulation and statutes of BMT; management; computerization; and performance assessment. It is the only organization providing statistics on BMT, but with its small staff is unable to do so regularly. The last official statistics, reporting 3037 BMT, date back to 2001.

PINBUK also supplies BMT with MIS. Along with TCTECH (TAMWIL Computerization Technology, Semarang) and since 2001 with PT USSI in Badang, PINBUK has developed a software package for BMT, divided in three categories: Single User, for small scale BMTs, at the price of Rp 1.5 million; Multi-user with Local Area Network capability for medium sized BMT, at the price of Rp 3.5-10.0 million (depending on asset size); and an advanced version

with on-line long distance network functionality (between head-office and branches) for large scale BMTs at the price of Rp20 million.

PINBUK operates at the head office with a staff of 14 in Jakarta. Since 1999, PINBUK has been establishing chapters at the district level, so that primary BMT would belong to the district chapters. This has now been achieved in 250 out of 360 districts, each a one-man operation. Some 18% of the PINBUK district offices have a business development officer responsible for BMT development and monitoring, but many of these staff are involved also in other activities.

PINBUK gets basic funding from YINDUK, which is funded from donations. Additional funding is received from the Ministry of Social Affairs, Ministry of Cooperatives, Ministry of Transmigration for special projects, eg, for establishing BMT in transmigration areas. The costs of training are covered from fees from the BMT. In some districts (approximately 5 out of 250), the BMT (approximately 100) pay regular monthly contributions to the district office; this system is expected to be expanded.

INKOPSYAH: Induk Koperasi Syariah is a parallel institution registered as a secondary-level cooperative since 1997, with a national office of 9 staff members in Jakarta. It functions as a wholesaler of funds from PNM and the Small Enterprise Development Fund PUKK (which receives contributions from the 5% profit share state enterprises have to devote to poverty alleviation and small enterprise development) and monitors the loans, but leaves TA in the hands of PINBUK. INKOPSYAH has some 500 primary level BMT-members registered with the MoC as cooperatives. To qualify as a member, total assets have to exceed Rp 500m. At the regional level, INKOPSYAH works through regional secondary cooperatives, Pusat Koperasi Kredit Syariah BMT (PUSKOP), which cooperate with PINBUK. The main function of the PUSKOP is to facilitate access of BMT to credit. They are also responsible for monitoring members and BMT that are non-members. As an example, the PUSKOP of Central Java employs 7 staff and funds its operations from fees from BMT for training and the sale of software; it also retains some margin on long-term loans (from the apex through PUSKOP to BMT), and from its ownership of five retail shops. At the end of September 2002 INKOPSYAH had total assets of Rp 2.6bn, with the major funding coming from PNM in the form of a 5 year subordinated loan of Rp 2bn at 19% interest p.a. In 2003 INKOPSYAH was instrumental in channeling Rp 15bn from PNM to BMT. It reports a good repayment performance and a profit of Rp 300m in 2003.

PNM: Permodalan Nasional Madani, is a commercially operating⁶ state-owned corporation, acting as a wholesale apex for financing small and medium enterprise programs or projects of commercial banks, rural banks (BPR) and cooperatives. While Bank Indonesia's functions have been concentrated on monetary policy, its various development banking functions have been divested in various other institutions, among them PNM as a replacement for BI's Liquidity credit program, KLBI, since June 1999. In cooperation with ASBISINDO and PINBUK, PNM also supports Islamic financial institutions: commercial banks, rural banks and cooperatives.⁷ The 85 BMT which are PNM borrowers are all registered with the MoC. The remaining 2500 are either dormant or weak. They require strengthening through (i) prudential regulation and effective supervision, which is the government's task; capacity-building which is presently done by PINBUK but should be the task of associations of BMT; and (iii) financial development by wholesale institutions like PNM. In the absence of supervision, PNM, with a vested interest in quality, has taken steps to set up a supervision team; its functions and authority are being discussed with the MoC. In the future PNM plans to put more emphasis on human resource development of BMT in cooperation with PINBUK and ASBISINDO, thus

⁶ In 2003, total assets were Rp 1.96tr, equity was Rp 415bn, ROA 3.5%, ROE 16.3%. (PNM 2004:66-69.

⁷ PNM, as of Dec. 2003, had 652 microfinance customers: 432 BPR and BPRS (out of a total of reportedly 1200 healthy rural banks); 135 KSP/USP (out of a total of 2500 healthy cooperatives); and 85 BMT (out of a total of 500 healthy Islamic cooperatives).

providing both financial and social capital. It is hoped that PNM's own quality management system⁸ will eventually reflect on the BPRS and particularly BMT which it refinances.

Bank linkages have been emerging, particularly with BMI and Bank Mandiri as well as with PNM as a wholesale apex. In 2002 Bank Mandiri allocated Rp 39.6 billion for on-lending to BMTs, provided through the Himbara Funds, taking 3% of its annual profit under the PUKK program. As of December 2002 the total amount disbursed through PINBUK at an interest rate of 6% p.a. was Rp 147 billion for 47,000 BMT members. The Bank has also conducted training for BMT staff. The major constraint for Bank Mandiri in assisting the BMTs is that most have no legal status and are not registered as cooperatives.

Muamalat Institute: For strengthening Islamic commercial and rural banks, BMI has established the Muamalat Institute for Research, Training, Consulting & Publication. For banking with the poor organized in BMT and KOPONTREN, BMI has established Baitulmaal Muamalat, which focuses on channelling funds from the MoC to Islamic cooperatives.

In addition to formal financing arrangements, BMTs receive substantial donations from wealthy Muslims. Management and supervision weaknesses are the major constraints for BMT, not funding.

Microfin is an agency established in 2001 with the objective channelling funds to BMT and KOPONTREN and facilitating their evolution into MFIs (LKM) according to the draft microfinance law of 2001 or inducing them to establish BPRS. It is funded from the channelling fees of from government projects, executing profit margins from commercial banks and profit-sharing from individual investors. It has 10 staff members. Microfin has established a network of 109 BMT and participates in a program of channeling funds through 7 projects to a total of 673 BMT and KOPONTREN, plus 24 BPRS (Dec. 2003).⁹ Its future plans are to stimulate the establishment of additional BPRS, mainly by inducing groups of 5-10 BMT to join together and establish BPRS, owned by larger numbers of shareholders.¹⁰ Another approach is for one large BMT to establish a BPRS for larger-scale commercial loans, while continuing as an unsupervised BMT for very small loans and social activities to the unbankable.

Affiliations of sample BMT: BMT At-Taqwa has no network affiliations, but follows the PINBUK format of reporting. It has received soft loans from BMI and PNM. It is affiliated to two religious institutions: the Mosque At-Taqwa, its founding institution; and Badan Amil Zakat, a religious tax management institution which provides soft loans free of charge. BMT Ibaadurrahman is affiliated to BMM and BUMN (Badan Usaha Milik Negara), two financial institutions from which it received financing of Rp 25m and Rp 33m, respectively, through the local cooperative authority. It is registered with PINBUK since 1998, but has received no services. It is attached to the local Pesantren. BMT Latenza is unaffiliated. BMT Wira Mandiri belongs to the PINBUK network and is an active participant.

⁸ ISO 9002-certified by TÜV.

⁹ The first two are government projects, the next two projects with commercial banks, the fifth is an NGO project, and the last two are projects with individual investors:

- P2KER, which has channeled Rp 47bn from MoC since 1997. Outstandings are Rp 12.8bn, overdues 55% (because these are government funds considered as grants)
- DBS, est. in 2003, with Rp 3bn outstandings invested in revolving funds; overdues are still 0%
- M3M established in 4/2004, with Rp 3bn outstandings
- LFM since 4/2004, with Rp 5.5bn outstandings
- IDF since 2000, with 0.2bn outstandings; overdues are 0%
- Deposito Mikro, (term deposits of Microfin), since 2000, amounting to Rp 100 million
- Invest Perorangan, since 2002, amounting to Rp 400 million; overdues are 0%.

¹⁰ The establishment of BPRS Sahid by 19 BMT is reportedly in progress in Tulung Agung, East Java. A feasibility study is in process; Rp 500m have been collected; licensing is expected as of mid-2005.

6. Summary, assessment and recommendations

6.1 Summary and assessment

(1) Financial sector framework

Indonesia possesses **one of the most differentiated microfinance infrastructures** in the developing world, with a history of more than 100 years. In the increasingly liberal policy environment of the past two decades, two types of *regulated microfinance institutions*, belonging to the formal banking sector, have gained prominence on the microfinance market:

- the units of the Microbanking Division of government-owned BRI, since 1984,
- and the rural banks (BPR), since 1988.

Together, they account for 95% of recorded deposits and 75% of loans outstanding among a total of 53,000 formal and semiformal microfinance institutions (MFIs). *Financial cooperatives*, which are unregulated semi-formal financial institutions, about 40,000 in number, account for another 5% of deposits and 18% of loans; they have suffered, rather than benefited, from preferential government treatment.

Microfinance is no panacea; but it has certainly contributed to the *reduction of poor* from 60% in 1970 to 11.5% in 1996. The financial crisis of 1997/98 interrupted this trend; poverty rates surged, but then fell again below 20%. At the same time, the BRI units emerged strengthened, the rural banking sector restructured from the financial crisis, the latter responding positively to the enforcement of prudential regulation. The cooperative sector, much of it presumably in an undiagnosed state of ill health, continues to be effectively unregulated and unsupervised. A major challenge to the commercial banking sector including the BRI units is *surplus liquidity* and thus the development of more effective lending instruments; a parallel challenge among rural banks and financial cooperatives is *liquidity shortage* and thus either the development of more effective savings mobilization instruments or more effective mechanisms of liquidity exchange.

Below are some of the **highlights of the financial sector framework for Islamic banking and microfinance** in Indonesia.

A conducive policy environment for Islamic banking and microfinance in Indonesia:

- A long history of banking and microfinance, dating back to 1895
- A highly differentiated rural financial infrastructure
- A deregulated policy and institutional framework since 1983
- An appropriate commercial and microbanking legal framework
- Favorable central bank regulation for Islamic banks
- BRI units as the most successful microfinance network in the developing world, serving as benchmark institutions
- Restructuring of the banking sector in response to the Asian financial crisis
- Increasingly effective prudential regulation and bank supervision
- A vast potential market for Islamic financial services in the largest Muslim country in the world
- **Key question:** Is there an effective demand for Islamic financial services?

Lack of a conducive sectoral framework for Islamic cooperatives:

- Lack of prudential regulation of financial cooperatives
- Lack of effective supervision of financial cooperatives
- Market distortions resulting from access to subsidized sources of finance
- Massive government interference in the cooperative sector in the past, but some incipient recent relaxation
- Cooperative sector in an undiagnosed state of ill-health
- **Key question:** Is there a chance for the development of sustainable Islamic cooperatives in Indonesia?

(2) Principles and typology of Islamic finance

Based on Islamic law, or sharia, Islamic finance is based on the ideal of a social order of brotherhood and solidarity and, more specifically, of a mutually beneficial partnership between depositor-investors, financial institutions with their staff and owners, and borrower-investors, who all share risks and benefits in various ways. It finds its purest expression in *mudarabah* deposit products, based on revenue-sharing, which are pervasive among commercial and rural banks, and *mudarabah* financing facilities (conventionally: *credit products*), based on profit-sharing partnerships, but adopted on a limited scale only in Indonesia. Most of the financings are based on *murabaha*, a sales contract with a fixed profit margin to the bank. The overall emphasis is on financing profitable investments only, backed by collateral. Speculative and other morally hazardous financial transactions as well as most forms of consumer lending are prohibited.

Islamic MFIs in Indonesia take it as their mandate to help the poor. Mistakenly, this has led many to believe that loans are akin to grants, or at least that leniency may be expected in meeting repayment obligations. In many cases, bank staff and borrowers had to learn the hard way that this is not so. Islamic MFIs do target the poor, but in actual fact only a segment of the poor: the enterprising poor. Lending to the poorest who lack resources and entrepreneurial experience would be hazardous and speculative; it would thus be contrary to the notion of a partnership between borrowers and the providers of capital, ie, depositors and bank owners. There is yet another market segment served by them: that of the enterprising poorest who lack experience but show promise. For these, some institutions offer another financial product, albeit on a very small scale: *qard* (or *qard hasan*), repayable in regular instalments and frequently backed by personal guarantees like other financings, but without a profit-sharing margin. Even rarer than *qard* financings are *qard* savings in Indonesia, usually for religious or social purposes.

Below are some of the **distinguishing characteristics of Islamic finance** in contrast to conventional banking and microfinance:

Principles of Islamic banking – in contrast to conventional banking:

- A social order based on cooperation, brotherhood and solidarity – in contrast to a social order based on competition which permits exploitation
- Mutually beneficial partnerships between banks and clients, depositors and borrower-investors – in contrast to diverging interests of the parties involved in transactions
- Symmetrical information-sharing (as an ideal) – in contrast to asymmetrical information (assumed to be withheld by the borrower to cheat the bank)
- Trust and confidence – in contrast to moral hazard as a constant threat in banking
- Financing solid real transactions only – in contrast to high-risk speculative and hazardous transactions
- **Key concepts:** Cooperation vs. competition; partnership vs. risky and exploitative relations

Typology of Islamic financial products :

- *Mudaraba* as a credit or deposit product based on mutually agreed upon variable ratios of profit or revenue sharing (difficult and costly to administer) – in contrast to fixed interest rates (transparent ex ante and simple to administer)
- *Murabahah* as the main credit product, a triangular sales contract in which the bank pays the seller and finances the buyer at a fixed profit margin – in contrast to a direct loan to the client, also at a fixed interest rate (at lower administrative but higher risk costs)

- *Qard Hasan* interest- or profit-free deposit products (rare in Indonesia¹) are the purest expression of the objection against interest-taking (*riba*) – non-existent in conventional banking
- *Qard Hasan* interest- or profit-free credit products are a pure form of social banking, either for charitable purposes or for start-up entrepreneurs without business experience and collateral – there is no equivalent in conventional banking
- Collateral as proof of a serious business relationship – in contrast to a safeguard in case of bankruptcy

Mandate and target group of Islamic MFIs:

- Helping the enterprising poor – in contrast to maximising profits from the most promising segments of the population

Special risks in Islamic finance:

- (Mis-) Interpreting brotherhood and partnership as leniency and loan forgiveness, resulting in loan delinquency (due to unwillingness to repay) – in contrast to seizing collateral in case of loan delinquency, resulting in bankruptcy (due to inability to repay).

(3) Beginnings of Islamic finance in Indonesia

Islamic finance in Indonesia has evolved since 1991, mainly in response to political demands from Muslim scholars and organizations for sharia-based financial services, as a complement to conventional forms of finance in the largest Muslim country. The first Islamic rural banks were established in 1991, followed by the first Islamic commercial bank in 1992. In 1998, Bank Indonesia gave official recognition, as part of the new banking act, to the existence of a dual banking system, conventional and Islamic, or sharia-based. This led to the establishment of a second Islamic commercial bank and, until December 2003, of eight Islamic commercial banking units (out of a total of 138 commercial banks), comprising a total of 255 banking offices, with a continuing upward trend. The growth pattern of Islamic rural banks has been quite different. After an initial period of growth until 1996 when they reached a total of 71, their number almost stagnated during and after the financial crisis, reaching 78 by 1998 and a mere 84 by 2003 (out of a total of 2134 rural banks). The first Islamic cooperative was established in 1990. Rapid expansion started after 1996, as a result of promotion by PINBUK, and continued throughout the financial crisis, but stagnated after 1999 at around 3000 and declined to less than 2,900 as of 2003 (out of a total of some 40,000 financial cooperatives).

Highlights of the **evolution of Islamic finance** in Indonesia include:

Origin and recognition:

- Due to initiatives in 1991 by Muslim scholars, not to popular demand
- Official recognition of a dual banking system, conventional and Islamic, by Bank Indonesia in 1998

Development:

- *Islamic commercial banks*: continuing upward trend since 1992; 2 Islamic banks and 8 Islamic banking units out of 138 commercial banks as of Dec. 2003
- *Islamic rural banks*: Initial growth since 1991 until 1996 followed by stagnation; 84 out of a total of 2134 rural banks as of Dec. 2003
- *Islamic cooperatives*: Start in 1990, rapid expansion after 1996, stagnation and decline since 1999; 2900 out of a total of 40,000 financial cooperatives as of Dec. 2003.

¹ By comparison, *Qard Hasan* (or *Qard ol-Hassaneh*) current and savings accounts are a major source of funds of banks in Iran. At the same time *mudarabah* or profit-sharing financings, which are of some importance in Indonesia, are virtually absent in Iranian banks.

(4) Islamic commercial banks in Indonesia

Overview: Islamic commercial banks (including banking units) account for 0.74% of total banking assets (2003); adding rural banks still yields the same percentage of 0.74%. This is a very small share; yet it is a big increase from a mere 0.17% in 2000. There is a remarkable difference in performance between conventional and Islamic commercial banks. In relative terms, (i) the Islamic banks lend more of the funds deposited, with a loans-to-deposits ratio (LDR, FDR) of 97% compared to 54% of the total commercial banking sector; and (ii) they lend them more successfully, with a gross non-performing loans ratio of 2.3% compared to 8.2% of the total commercial banking sector. However, due to rapid expansion, the return on assets (ROA) of Islamic commercial banks is only 0.65%, compared to 2.12% of the commercial banking sector. 89% of the deposits in Islamic commercial banks and banking units are revenue-sharing deposits, with returns determined ex-post, which is non-existent in conventional banking. 20% of financings (or loans) are profit-sharing, 71.5% are fixed rate trade financings (*murabahah*), which are little different from conventional banking.

Concluding assessment: The performance of the Islamic banks and banking units has motivated an increasing number of banks to announce the opening of Islamic banking units; continued growth of the Islamic commercial banking sector may be expected.

Islamic vs. conventional commercial banks, Dec. 2003

	<i>Islamic</i>	<i>Conventional</i>	<i>Total</i>
Date of origin of first bank	1992	1895	
Total number of banks/banking units	10	136	138 + 8 units
Total number of banking offices Including BRI units:	255	7,475 11,524	7,730 11,779
Total banking assets	0.74%	99.36%	100.0%
Total loans outstanding	1.16%	88.84%	100.0%
Total deposits	0.64%	99.36%	100.0%
Loans-to-deposits ratio (LDR, FDR)	97%		54%
Non-performing loans ratio (NPLR)	2.3%		8.2%
Improvement in NPLR 2000-2003	13.0% to 2.3%	26.8% to 8.2%	
Return on assets	0.65%		2.12%

Islamic vs. conventional commercial banks:

- The share of Islamic commercial banks is a mere 0.74% of total banking assets
- But they have grown fourfold over the past three years, and their non-performing assets are only a quarter of those of conventional banks: presumably due to their focus on prudent, non-speculative lending (perhaps also due to highly selective lending during their start-up phase)
- They have benefited from a much-strengthened role of the central bank in prudential regulation and effective supervision and from enthusiasm for Islamic banking among established commercial banks
- Islamic commercial banks may have a great potential in developing sustainable microfinance services of increasing volume and outreach, following the example of the microbanking units of Bank Rakyat Indonesia², a world leader in microfinance

(5) Islamic rural banks (BPRS)

Overview: Islamic rural banks are part of the regulated and – at least during the last few years – effectively supervised rural banking sector, based on the rural banking law of October 1988 which defines rural banks as part of the formal banking sector, together with commercial banks. Islamic rural banks started to evolve only two years after conventional rural banks (BPR) came into existence, but at very different speeds: the number of

² Note should be taken that BRI has recently established an Islamic banking unit, which so far has been kept apart from the its Microbanking Division.

conventional BPR reached 2050 in December 2003, the number of Islamic BPRS 84 – in a predominantly Muslim country! While the number of conventional BPR grew at an average rate of 137 banks per year and the number of newly established BPR at a rate of 85.5 (excluding those that were converted from previously existing institutions), the growth rate of BPRS was a mere 6.5 banks annually. BPRS account for a mere 1.5% of total assets, 1.5% of total loans outstanding and 1.2% of total deposits of the total regulated BPR sector. Moreover, BPRS are much smaller, with only 38% of the assets of an average BPR; and their asset growth rates, at 70% over a three-year period, are much lower than those of the BPR sector at 173%. There are no data to compare the performance of conventional and Islamic rural banks; information on NPL and ROA is not available. Both sub-sectors have experienced closures in recent years.

Regional distribution: As of December 2003, there were 84 BPRS and 2050 conventional BPR. The majority of BPRS (62%) are located on Java, two-thirds of these in western Java. 23% are on Sumatra and 8% on Sulawesi.

Mandate, ownership, governance and supervision: Most BPRS are privately owned. They have a dual mandate, social and commercial, which may be one of the reasons of their slow growth. Conventional BPR, in contrast, are primarily oriented to profit-making, though their owners may also feel some commitment to the local community. Islamic rural banks cater for the enterprising poor in the informal sector, leaving out the more profitable sectors of salary earners and small entrepreneurs on the one hand and the poorest on the other hand. The percentage of clients below the poverty line in four sample BPRS was estimated at 6%. The owners of BPRS are mostly absentee-owners and rarely involved in the management of the bank. In contrast, owners of conventional BPR are frequently owner-managers. Each BPRS has a sharia board, a management board and a supervisory board, each with its own problems: there is no historical experience with Islamic banking in Indonesia; many of the managers are retired government bankers who lack the drive of a private banker; the controllers are usually far and remote. Banking supervision is effectively carried out by Bank Indonesia, which has closed four out of 90 BPRS ever licensed between 1991 and June 2004.

Delivery system: The four sample BPRS have on average two branches and 21 staff members, half of them loan officers including collectors with door-step services. Incentives are limited to an annual bonus which is not tied to individual performance. In line with the *mudabah* principle, some BPRS are discussing the introduction of profit-sharing between staff and owners as a substitute for a fixed salary.

Market and outreach: There are no statistics on the outreach of BPRS. Total depositor outreach of the BPRS sector may be estimated at 83,000, or less than 1000 per bank; total borrower outreach at around 30,000, or 350 per BPRS. 84% of the clients in five sample BPRS were small (itinerant) traders and microentrepreneurs; around 25% were women. Virtually all clients have an existing business. The very poor are expected to seek employment in a larger enterprise, which might be financed by an Islamic commercial bank.

Total assets and sources of funds: The average BPRS as of Dec. 2003 has total assets of US\$ 270,000; the average conventional BPR is almost three times larger. Deposits are the main source of funds (57% of total assets) in BPRS, followed by equity including reserves and current year profits (23%), bank deposits (11.5%) and borrowings (4%). The loans-to-deposits ratio in all BPRS is 126%, compared to 103% in the total BPR sector.

Financial services: Revenues (not profits!) of withdrawable savings deposits are shared in the five sample BPRS between clients and banks. The ratios of revenue-sharing vary widely between institutions and clients; the average ratio is 40:60, resulting in an average return of 8.3% during 2003; revenues of fixed deposits are shared at 60:50 on average, with an effective return of 13%. Most of the financings are based on *murabaha* (86% of financings in

five sample BPRS, unweighted average): a sales contract with a fixed margin, which is better understood by the borrowers and easier to handle for the bank than . As common in Indonesia, instalments are monthly or weekly (sometimes daily). The mark-ups are mostly flat rates, averaging 55% effective p.a. among the five sample banks, which is probably close to the average lending rate of BPR in Indonesia; only the BRI units are lower (averaging ~35% eff. p.a.). Compared to BMI, the first Islamic commercial bank in Indonesia, BPRS pay slightly more on deposits, but charge 3-4 times as much on financings.

Economic performance: No data are available on the performance of the BPRS sector as whole. Their emphasis on financing only profitable activities should give them a comparative advantage, their much smaller size, governance problems and market restrictions a disadvantage. In four sample BPRS, which are far bigger than the average BPRS, the average non-performing loan ratio was 4.6%, the average ROA 3.2%, compared to an NPL of 2.5% and a ROA of 5.7% in the benchmark BRI units.

Affiliations and support: *Asosiasi Bank Syariah Indonesia (ASBISINDO)* was established in 1992 as an association of Islamic rural banks; since 2002 its coverage also includes Islamic commercial banks. The two Islamic commercial banks, 7 out of 9 Syaria units of commercial banks and 82 BPRS are members of Asbisindo. Its main activity is the training of management and staff of Islamic commercial banks and rural banks. *PNM*, a government corporation which has replaced Bank Indonesia's small credit department, refinances BPR and BPRS and other conventional and Islamic financial institutions and supports their capacity development.

Concluding assessment: After 13 years of development of Islamic rural banks and 15 years of development of a regulated rural banking sector in Indonesia, Islamic rural banks still constitute **a minute part of the rural banking sector as well as of the total Islamic banking sector, with no prospects of growth:**

- 4% of the total number of rural banks (BPR/S)
- 1.5% of total assets the rural banking sector³
- 0.02% of the total banking sector
- 2.4% of the total Islamic commercial and rural banking sector assets
- 1.5% of total loans outstanding of the rural banking sector
- 1.2% of total deposits of the rural banking sector.

Total outreach of Islamic rural banks amounts to 83,000 deposit accounts and 30,000 credit accounts, totalling 113,000 accounts held by perhaps 82,000 people; this is:

- 1.5% of the outreach of the total rural banking sector and
- 0.14% of the total microfinance sector.

³ Rural banks account for 1.2% of total assets of the banking sector.

Islamic vs. conventional rural banks, Dec. 2003

	<i>Islamic</i>	<i>Conventional</i> ⁴	<i>Total</i>
Date of origin of first rural bank (BPR/S)	1991	1989	
Total number of BPR/S as of Dec. 2003	84	2050	2134
<i>Percent of BPR sector</i>	<i>4%</i>	<i>96%</i>	<i>100%</i>
Number of newly established BPR/S as of June 2002 (see footnote). <i>Percent:</i>	83	1283	1365
	<i>6%</i>	<i>94%</i>	<i>100%</i>
Av. number of BPR/S p.a. since origin	6.5	136.7	
Total rural banking assets	1.5%	98.5%	100%
Size of BPRS in % of average BPR	38%		
Asset growth during 2000-2003	70%	175%	173%
Total loans outstanding	1.5%	98.5%	100.0%
Total deposits	1.2%	98.8%	100.0%
Loans-to-deposits ratio (LDR, FDR)	126%	103%	103%
Non-performing loans ratio (NPLR)	n.a.	n.a.	n.a.
Return on assets	n.a.	n.a.	n.a.
Total outreach:			
Rural banking sector	1.5%	98.5%	100.0%
Microfinance sector	0.14%	99.86%	100.0%

Islamic vs. conventional rural banks:

- Regulated Islamic and conventional rural banks have evolved over almost the same time period, 13 and 15 years, respectively
- Islamic rural banks have remained small. The volume of their services is negligible, compared to conventional rural banks, accounting for only 4% in number, 1.5% in assets as well as outreach, and 1.2% of deposits
- Their growth in numbers has stagnated in recent years; and their growth in assets has remained far behind that of conventional rural banks
- Lack of popular demand for Islamic banking services, absentee ownership, lack of young dynamic management, lack of mastery of overly complex Islamic banking practices, and emphasis on the informal sector and the poor to the neglect of more profitable market segments are among the many reasons for their retarded development

(6) Islamic cooperatives (BMT)

Overview: Islamic cooperatives suffer from the same benign regulatory neglect as conventional cooperatives. There is no overall supervision and no systematic recording of either conventional or Islamic cooperatives (BMT); most BMT (83% according to a BI estimate) are not even registered with the Ministry of Cooperatives. After a period of rapid growth after 1995 when PINBUK assumed their promotion, they are now in decline; the majority of the 3000 BMT now are assumed to be dormant or technically bankrupt. PINBUK has no power to enforce reporting, much less so prudential regulation; the Ministry has the power, but does not use it, and may in fact be an inappropriate organization to do so. All general information provided in this report on cooperatives is therefore of questionable validity. In recent years, efforts have been made to improve the quality of cooperatives, reportedly with initial success in some areas like Central Java.

There are around 2900 Islamic cooperatives (BMT), constituting 7.2% of all financial cooperatives, 2.9% of their deposits and 1.1% of loans outstanding. Borrower outreach is

⁴ The law (PAKTO27) authorizing the establishment of rural banks (BPR) was passed in October 1988; the first regulated BPR were established in 1989; but the first predecessor institution, the Rural Bank of Purwokerto, was established as early as 1895. By June 2002, 1365, or 62% out of a total of 2213 BPR had been newly established, 1283 of them conventional – a figure which is still fifteen times larger than the number of BPRS.

reported as 73,000 accounts⁵, which is less than 1% of total borrower outreach of the financial cooperative sector. There is no information on the number of deposit accounts.

Regional distribution: The majority of the 2900 BMT (60% in 2003), like BPRS, are located on Java, but are spread far more equally over western, central and eastern Java. 20% are on Sumatra, 12% on Sulawesi. BMT are underrepresented on Kalimantan and the smaller islands.

Mission, legal status, governance and supervision:

The BMT in our sample see it as their mission to help the enterprising poor, particularly very small microentrepreneurs including food vendors (*kaki-lima*). Only an estimated 500 out of 3000 BMT are registered as financial cooperatives with the Ministry of Cooperatives. It is not expected that the draft microfinance law of 2001, which might have provided a legal framework, will be enacted within the foreseeable future. As cooperatives, BMT are owned by their members; but there is frequently a distinction between a small number of voting members, who are share-holders, and associated members. Board size and composition are not standardized, but on principle similar to that of BPRS. Only about 50% report to their local PINBUK. INKOPSYAH receives monthly reports from its members as a prerequisite of access to sources of refinancing. PINBUK has no formal supervisory powers; a supervision project was short-lived as funds ran out. Officials from the Ministry of Cooperatives rarely go beyond attending annual meetings when invited. There is no external auditing. In general, supervisory arrangements, enforcement of standards, information and reporting are either absent or ineffective.

Delivery system: In the four sample BMT, the average number staff is close to four, half of them loan officers or collectors. The average service radius is about 14 km. BMT normally do not have branches.

Market and outreach: The majority of BMT clients are small and itinerant traders and other microentrepreneurs. There is no reliable information on outreach. We estimate total saver and borrower outreach at around 1.7million, but probably only about one-third of them active.

Total assets and sources of funds: The median asset size per BMT is estimated by PINBUK at Rp 250 million (US\$ 24,000) as of 2001. 2% were listed with asset sizes above Rp 1 billion, 9.5% with asset sizes below 50 million. Deposits are the main source of funds, followed by capital. In contrast to conventional cooperatives, borrowings in BMT seem to be of minor importance; the mean loan portfolio is almost matched by deposits (LDR = 103%).

Financial services: The question about the difference between Islamic and comparable non-Islamic institutions evoked little response. Deposit products are mainly based on mudarabah, ie, revenue-sharing between clients and BMT: The average ratio in the four sample BMT for savings accounts is 34:66, average annual returns are 8.8%; the respective values for term deposits are 42:58 and 13.6% - insignificantly higher than in the sample BPRS.

The average number of loan accounts in the four sample BMT, which are far above the national average in size, is 327. Loan sizes are less than half the volume of those in the sample BPRS. In the sample BMT, 61.5% of financings are murabahah, ie, a sales contract between bank and client – less than in the BPRS. Mudarabah, based on profit-sharing, with a share of 32%, and qard al-hassan, a free loan product for poor start-ups with a share of 3.5%, are relatively more important. Requiring collateral is standard. In some cases there are compulsory savings around 5%. Effective annual mark-ups, or profit margins to the bank, are around 50%. It is common not to charge penalties on late payments. Given a sample size of 4 out of 2900, all these figures may not even be indicative.

⁵ The validity of this figures is questionable.

Economic performance: In the absence of effective regulation and supervision, the performance of BMT is very uneven; information is sporadic. A large number of BMT may be dormant, and members inactive. PNM has identified 500 BMT, which are members of INKOPSYAH and registered with the MoC, as worth strengthening; this is less than one-fifth of the total number. In the four sample BMT, NPF ratios vary widely, from 1.4% to 30%, but are mostly estimates. All four BMT in our sample show positive returns on year-end assets, with ROAs ranging from 0.16% to 2.7%; but these figures are not reliable as sizeable bad debts may not have been written off. In three regional studies of MFIs by the ADB team (2003), the BRI units came out first as sustainable institutions with wide outreach and excellent performance; in two of these, the BMTs came out as complete failures, while in the third the BMT, after restructuring and after considerable capital injections, showed promise. BPRS were not found in the sample.

Affiliations and support: The most important promoter of Islamic cooperatives is PINBUK, the Centre for Micro Enterprise Incubation, established in 1995 by YINBUK, a foundation, as its operational arm. It provides a MIS to BMT and, through regional offices, basic, intermediate and advanced training, plus training of trainers. While PINBUK provides technical assistance, *INDOPSYAH*, a commercially operating secondary-level cooperative, functions as a wholesaler of funds from PNM and other sources. *Microfin* has established a network of 109 BMT and channels project funds to a total of 673 BMT and KOPONTREN, plus 24 BPRS; it also tries to promote their institutional upgrading to MFIs (LKM) or BPRS. PNM, which has replaced BI's liquidity credit operations, has provided liquidity to 85 BMT. To step up its outreach and effectiveness, it will cooperate with PINBUK and ASBISINDO to provide supervision and on human resource development services, thus strengthening both the financial and social capital of BMT. Additional financial resources are provided by Islamic banks. BMI, the first Islamic bank, channels funds through *Baitulmaal Muamalat* and technical assistance through the *Muamalat Institute for Research, Training, Consulting & Publication*. BMTs also receive donations from wealthy Muslims. The main constraints for BMT are management and supervision weaknesses, not funding.

Concluding assessment: The outreach of Islamic cooperatives is negligible, their overall performance poor; for several years they have been **in decline**:

- There is a complete lack of regulation, supervision and reliable reporting
- The large majority of them is reported to be dormant or technically bankrupt
- Their outreach is negligible, accounting for 7.2% of all financial cooperatives, but less than 1% of borrower outreach of the sector
- Their loan portfolio (much of it overdue) accounts for 1,1% of the financial cooperative sector and 0.19% of the microfinance sector
- The savings of the depositors are at great risk.

Islamic vs. conventional cooperatives

	<i>Islamic</i>	<i>Conventional</i> ⁶	<i>Total</i>
Total number of financial cooperatives*	2900	37,627	40,527
<i>Percent of fin. cooperative sector</i>	7.2%	92.8%	100.0%
Total assets	n.a.	n.a.	n.a.
Total loans outstanding	1.1%	98.9%	100.0%
Total deposits	2.9%	97.1	100.0%
Loans-to-deposits ratio (LDR, FDR)	90%	34%	35%
Non-performing loans ratio (NPLR)	n.a.	n.a.	n.a.

⁶ The law (PAKTO27) authorizing the establishment of rural banks (BPR) was passed in October 1988; the first regulated BPR were established in 1989; but the first predecessor institution, the Rural Bank of Purwokerto, was established as early as 1895. By June 2002, 1365, or 62% out of a total of 2213 BPR had been newly established, 1283 of them conventional – a figure which is still fifteen times larger than the number of BPRS.

Return on assets	n.a.	n.a.	n.a.
Total outreach: credit accounts**	0.7%	99.3%	100.0

* Source: Table 1.1, preliminary figures; there are no authoritative data on the cooperative sector.

** There is no information on the number of deposit accounts in BMT.

Islamic vs. conventional financial cooperatives:

- The whole cooperative sector has historically suffered from a complete lack of regulation and supervision, paralleled by excessive government interference and subsidies which have distorted rural financial markets and undermined self-help
- The majority of Islamic cooperatives are reportedly dormant or technically bankrupt
- Outreach and volume of services of Islamic cooperatives are negligible compared to conventional cooperatives, which are also in a state of acute but undiagnosed ill-health
- The savings of depositors are at great risk; cooperatives should not be authorized to accept savings of non-members
- No remedy is in sight.

(7) Conclusion

Islamic finance, after 13 years, accounts for 0.74%⁷ of total assets of the banking sector: a negligible proportion. However, since Bank Indonesia gave official recognition to a dual banking system, conventional and Islamic, enthusiasm for Islamic finance spread among commercial banks, fuelled by low rates of non-performing loans, and the share of Islamic commercial banks more than quadrupled during the last three years, 2001-2003: from 0.17% to 0.74%.

Islamic rural banks (BPRS), providers of microfinance services, are under the same effective prudential regulation and supervision as commercial banks and conventional rural banks (BPR). After a promising start in the early 1990s, their development has almost come to a standstill. Despite the fact that they had only two years less than conventional BPR, which started to evolve after the rural banking act of 1988, and despite the special services provided by the Islamic Banking Directorate of Bank Indonesia, they have attained a mere 4% of the number and 1.5% of the assets of the rural banking sector; and their growth in recent years has been much slower than that of the conventional rural banks:

- The number of BPRS grew by 6.5, conventional BPR by 137 banks p.a.
- Average assets of BPRS amount to only 38% of the assets of conventional BPR.
- During 2001-2003, total assets of the BPRS grew by 70%, the BPR sector by 173%.

Islamic financial cooperatives suffer from the same regulatory and supervisory neglect as the rest of the sector. After a period of rapid growth during most of the 1990s, they are now in decline, with perhaps not more than one-fifth expanding and in good health. Fresh money pumped into the BMT sector without effective regulation and supervision including mandatory auditing will further contribute to their downfall, as has been the case in the state-supported KSP/USP sector.

⁷ The percentage remains the same when including the assets of Islamic rural banks and those of Islamic financial cooperatives.

6.2 Recommendations

Options: On the factual basis of thirteen years of experience with Islamic banking in Indonesia, decision-makers now are confronted with two major options:

- (1) Focusing fully on the Islamic commercial banks in Indonesia and assisting them to establish branch networks of Islamic microfinance institutions
- (2) Re-assessing in a participatory process the challenges and realistic opportunities of Islamic rural banks and cooperatives, taking into consideration the lack of broad popular demand, be it from poor or non-poor, and the lack of dynamic growth.

Risks and constraints: It is beyond the scope of this preliminary study to submit a definitive recommendation as to option 1 or 2. However, policymakers should be aware that the Islamic commercial banks are on the right track of becoming a healthy and rapidly growing sub-sector of the commercial banking sector; that potential could be further utilized to give them a stronger role in microfinance. Examining their strengths and weaknesses was not part of this study; but there was sufficient evidence to arrive at the conclusion that they already stand on their own feet and are in the process of rapid development, both in quantitative and qualitative terms. Islamic banking, with its variable and flexible ratios of revenue-sharing with depositors and profit-sharing with borrowers is unduly complicated. Only commercial banks appear to be able of acquiring the art of Islamic banking by training young and dynamic people.

The same cannot be said of the Islamic rural banks and the Islamic cooperatives: the former – in contrast to conventional BPR – have failed to prove themselves as effective and efficient providers of microfinance services; the latter are an outright menace to their shareholders and depositors, who are at great risk to lose their money. In most BPRS, the retired conventional bankers (experienced bankers must be hired according to BI regulation) find it difficult to learn and apply the art of Islamic banking; and their sharia boards are frequently not more experienced.

Opportunities: We recommend to decision-makers in Islamic organizations, government agencies and donor organizations to critically examine the following opportunities for the development of a healthy Islamic financial sector in Indonesia:

- **Islamic commercial banks**, in setting up branch networks of Islamic MFIs, may learn **with good prospects** from the rich experience of successful microfinance strategies and institutions within Indonesia, in particular:
 - (1) from the experience of the units of the Bank Rakyat Indonesia Microbanking Division, one of the most successful microfinance programs in the developing world; and
 - (2) from Bank Indonesia's program *Linking Banks and Self-Help Groups*, a financial technology of extending the outreach of banks to low-income people at reasonable transaction costs
- **Islamic rural banks** need to be revamped if they are to play a more than marginal role in Indonesia. This requires an overall development plan for the BPRS sector mutually agreed upon by all stakeholders. With some reservation, due to **poor prospects** if there is anything to be learned from past history, we recommend to the stakeholders the following:
 - (1) Establishing a strong banking association to provide a full range of support services to their members on a cost-covering basis; a much-strengthened

- ASBISINDO, perhaps in cooperation with GTZ's ongoing microfinance Project (ProFI), may promote such an association⁸ or provide those services ad interim
- (2) Selecting some of the most successful Islamic rural banks as demonstration and exposure learning sites, to provide apprenticeship and extended exposure training to staff and future managers
 - (3) A farther-reaching option would be a dual training system to prepare young dynamic graduates for management positions (instead of relying on elderly retired bankers)
 - (4) Developing more effective savings products and strategies as a substitute for borrowings
 - (5) Mandatory auditing should be extended to all BPRS, regardless of size
 - (6) Bank Indonesia should be encouraged to continue providing guidance, enforcing prudential rules and closing defunct BPRS.
 - (7) For the rapid expansion of the BPRS network, absentee owners may be interested in a *Build-Transfer-Operate* approach, perhaps as part of a franchising model, with profit-sharing between the franchiser and the franchisee.

➤ **Islamic cooperatives** suffer from much the same set of problems as the whole cooperative sector; there is little chance for any intervention to be successful in the short run:

- (1) They most urgently need a system of prudential regulation, mandatory auditing, and effective supervision by an appropriate financial authority (perhaps delegated to an autonomous auditing federation, but definitely not in the hands of a ministry).
- (2) They should be fully financed through member equity and savings deposits of members; only healthy and well supervised cooperatives should be permitted to collect deposits from non-members.
- (3) They should develop more effective savings products and strategies as a substitute for borrowings
- (4) The services of organizations whose sole purpose is channelling of project funds should be phased out.
- (5) Like Islamic rural banks, Islamic cooperatives need strong associations and federations to provide a full range of support services to their members on a cost-covering basis; a much-strengthened PINBUK is one of the organizations that may promote such associations or provide those services ad interim
- (6) Associations and federations may be strengthened to the point where they may replace a governmental agency like the Ministry of Cooperatives, which, in the framework of massive government interference by the previous political system, seems to have been more detrimental than constructive in building self-reliant and healthy cooperatives
- (7) Some of the most successful Islamic cooperatives may be selected as demonstration and exposure learning sites: providing apprenticeship and extended exposure training to staff and future managers.

⁸ The structure and functioning of bank associations in developed countries, like the associations of cooperative banks (DRGV) and savings banks (DSGV) in Germany, may serve as examples and perhaps partners in development.

A note on Islamic finance in the province of Aceh after the Tsunami

Of all areas devastated by the Tsunami of 26 December 2004, the province of Aceh has been hardest hit. Providing relief and reconstructing the livelihoods of the surviving victims is the immediate task; reconstructing the physical and institutional infrastructure will have to come next. If the efforts at reconstruction are to lead to sustainable development, rural and microfinance will have an important role to play.

For political reasons, Aceh has been isolated in the past from mainstream development. The challenge is thus not just reconstructing, but laying the foundations for a sound system of rural and microfinance institutions. All those impoverished by the floods, as well as everybody else, need access to sustainable financial institutions for depositing savings including relief benefits and obtaining credit. As I have shown elsewhere (*Seibel 2003a*), relief benefits are likely to be wasted, or limited in their effectiveness, if victims have no access to financial services.

The people of Aceh adhere strongly to the principles of Islam, including those of Islamic finance; taking or charging interest (*riba*) is against their religious conviction. Despite its isolation, Aceh has 5 Islamic rural banks, established during 1991-95, and 76 Islamic cooperatives, of which less than 20 are reportedly functioning. This is a beginning, but not an adequate structure of Islamic finance. Building strong Islamic financial institutions in Aceh could be of enormous benefit to the reconstruction and development of the province. Thereby Aceh could become the province benefiting most from the results of this study on the positive and negative experience of Islamic finance in Indonesia.

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BALANCE SHEET & INCOME STATEMENT OF BPRS, 2003

No	ITEMS	Jumlah Jabotabek	Jumlah Wil. KBI	TOTAL NERACA NASIONAL
1	Kas	1.218.686	2.438.758	3.657.444
2	Sertifikat Bank Indonesia	-	-	-
3	Antarbank Aktiva	9.128.753	22.760.482	31.889.235
4	Kredit Yang Diberikan	50.453.310	88.107.877	138.561.187
5	Penyisihan Aktiva Produktif (-/-)	(1.189.702)	(3.270.066)	(4.459.768)
6	Aktiva Dalam Valuta Asing	-	-	-
7	Aktiva Tetap dan Inventaris	2.045.709	6.825.872	8.871.581
	a. Tanah dan Gedung	811.433	2.968.067	3.779.500
	b. Akumulasi Penyusutan Gedung (-/-)	(40.961)	(203.929)	(244.890)
	c. Inventaris	2.567.268	6.933.812	9.501.080
	d. Akumulasi Penyusutan Inventaris (-/-)	(1.292.031)	(2.872.078)	(4.164.109)
8	Antarkantor Aktiva	-	-	-
9	Rupa-rupa Aktiva	2.239.035	10.991.650	13.230.685
	Jumlah Aktiva	63.895.791	127.854.573	191.750.364
1	Kewajiban yg. Segera Dibayar	397.434	1.293.485	1.690.919
2	Tabungan	17.638.210	40.935.885	58.574.095
3	Deposito Berjangka	22.093.054	29.331.737	51.424.791
4	Bank Indonesia	650.000	517.900	1.167.900
5	Antarbank Pasiva	8.564.800	12.350.535	20.915.335
6	Pinjaman Diterima	1.339.206	5.898.703	7.237.909
	a. Pinjaman Subordinasi	3.100	-	3.100
	b. Lainnya	1.336.106	5.898.703	7.234.809
	i. Sampai Dengan 3 Bulan	227.222	-	227.222
	ii. Lebih Dari 3 Bulan	1.108.884	5.898.703	7.007.587
7	Antarkantor Pasiva	-	-	-
8	Rupa-rupa Pasiva	909.029	5.844.904	6.753.933
9	Modal	11.539.936	26.050.883	37.590.819
	a. Modal Dasar	13.213.000	38.237.000	51.450.000
	b. Modal yg. Blm. Disetor (-/-)	(4.595.760)	(15.849.900)	(20.445.660)
	c. Modal Sumbangan	851.188	292.601	1.143.789
	d. Modal Pinjaman	2.071.508	3.371.182	5.442.690
10	Cadangan	816.678	2.898.292	3.714.970
	a. Cadangan Umum	563.346	1.527.447	2.090.793
	b. Cadangan Tujuan	177.196	710.563	887.759
	c. Laba Yang Ditahan	76.136	660.282	736.418
11	Laba/Rugi	(52.556)	2.732.249	2.679.693
	a. Tahun Lalu	(453.972)	1.889.516	1.435.544
	i. Laba Tahun Lalu	1.593.485	4.457.001	6.050.486
	ii. Rugi Tahun Lalu (-/-)	(2.047.457)	(2.567.485)	(4.614.942)
	b. Tahun Berjalan	401.416	842.733	1.244.149
	i. Laba Tahun Berjalan	493.226	1.047.077	1.540.303
	ii. Rugi Tahun berjalan (-/-)	(91.810)	(204.344)	(296.154)
	Jumlah Pasiva	63.895.791	127.854.573	191.750.364
	Modal	12.304.058	31.681.424	43.985.482
	aktiva produktif	50.453.310	88.107.877	138.561.187
		24,39%	35,96%	31,74%
	ROA (current year)	46 0,63%	0,66%	0,65%
	ROE (current year)	3,48%	3,23%	3,31%
	PPAP/AP	2,36%	3,71%	3,22%

Annex 4: LIST OF BPRS (JUNE 2004)

No.	Legal Body	Name of BPRS	Date of License	Date of Operation	Kab/Kotamadya/City	Propinsi/Province
1	PT (Ltd.)	Ibadurrahman	Sep 93	Okt 93	Penajam Paser Utama	Kalimantan Timur
2	PT (Ltd.)	Hareukat	Okt 91	Nov 91	Aceh Besar	Nanggroe Aceh Darussalam
3	PT (Ltd.)	Baiturrahman	Mrz 94	Apr 94	Aceh Besar	Nanggroe Aceh Darussalam
4	PT (Ltd.)	Tengku Chiek Dipante	Mrz 94	Apr 94	Pidie	Nanggroe Aceh Darussalam
5	PT (Ltd.)	Hikmah Wakilah	Jul 95	Jul 95	Banda Aceh	Nanggroe Aceh Darussalam
6	PT (Ltd.)	Sakai Sambayan	Jan 96	Feb 96	Lampung Selatan	Lampung
7	PT (Ltd.)	Daya Murni Sejahtera	Mrz 97	Apr 97	Tulang Bawang	Lampung
8	PT (Ltd.)	Berkah Amal Sejahtera	Jul 91	Jul 91	Bandung	Jawa Barat
9	PT (Ltd.)	Dana Mardhatilla	Jul 91	Jul 91	Bandung	Jawa Barat
10	PT (Ltd.)	Amanah Rabbaniah	Sep 91	Okt 91	Bandung	Jawa Barat
11	PT (Ltd.)	Mentari	Jan 93	Feb 93	Garut	Jawa Barat
12	PT (Ltd.)	Baitur Ridha	Jun 93	Sep 93	Bandung	Jawa Barat
13	PT (Ltd.)	Babusaalam	Nov 93	Nov 93	Bandung	Jawa Barat
14	PT (Ltd.)	Dana Tijarah	Dez 93	Jan 94	Cimahi	Jawa Barat
15	PT (Ltd.)	Mukarramah	Mrz 94	Mrz 94	Bandung	Jawa Barat
16	PT (Ltd.)	Al Ma'soem Syari'ah	Mai 94	Jul 94	Bandung	Jawa Barat
17	PT (Ltd.)	Harum Hikmah Nugraha	Jun 94	Jul 94	Garut	Jawa Barat
18	PT (Ltd.)	Artha Sakinah	Aug 94	Aug 94	Cianjur	Jawa Barat
19	PT (Ltd.)	Ishlalul Ummah	Sep 94	Feb 94	Cimahi	Jawa Barat
20	PT (Ltd.)	Artha Fisabilillah	Apr 95	Jun 95	Cianjur	Jawa Barat
21	PT (Ltd.)	Tolong Menolong Bermanfaat (To'at) Baleendah	Jan 96	Mrz 96	Bandung	Jawa Barat
22	Koperasi (Cooperation)	Al Ihsan	Mai 95	Jun 95	Bandung	Jawa Barat
23	PT (Ltd.)	Berkah Gemadana	Sep 93	Okt 95	Banjar	Kalimantan Selatan
24	PT (Ltd.)	Muamalat Harkat	Jan 96	Jan 96	Bengkulu Selatan	Bengkulu
25	PT (Ltd.)	Syarif Hidayatullah	Feb 94	Mrz 94	Cirebon	Jawa Barat
26	PT (Ltd.)	Syariat Fajar Sejahtera Bali	Apr 94	Mai 94	Badung	Bali
27	PT (Ltd.)	Muamalat Yofeta	Feb 98	Mrz 98	Jayapura	Papua
28	PT (Ltd.)	Artha Sinar Mentari	Jul 94	Sep 94	Jember	Jawa Timur
29	PT (Ltd.)	Amanah Ummah	Jul 92	Jul 92	Bogor	Jawa Barat
30	PT (Ltd.)	Artha Karimah Irsyadi	Okt 92	Nov 92	Bekasi	Jawa Barat
31	PT (Ltd.)	Bina Amwalul Hasanah	Dez 92	Feb 93	Depok	Jawa Barat
32	PT (Ltd.)	Inti Raqqat	Dez 92	Dez 92	Tangerang	Banten
33	PT (Ltd.)	Harta Insan Karimah	Aug 93	Sep 93	Tangerang	Banten
34	PT (Ltd.)	Baituniaga Insani	Okt 93	Okt 93	Bekasi	Jawa Barat
35	PT (Ltd.)	Saleh Artha	Dez 93	Jan 94	Bekasi	Jawa Barat
36	PT (Ltd.)	Tijari Baitul Maal	Apr 02	Apr 02	Tangerang	Banten
37	PT (Ltd.)	Baitul Muawanah	Aug 94	Sep 94	Cilegon	Banten
38	PT (Ltd.)	Attaqwa Garuda Utama	Okt 94	Okt 94	Tangerang	Banten
39	PT (Ltd.)	Wakalumi	Jan 95	Apr 95	Tangerang	Banten
40	PT (Ltd.)	Darma Amanah	Mai 95	Jun 95	Lebak	Banten
41	PT (Ltd.)	Al Barokah	Jan 96	Mrz 96	Depok	Jawa Barat
42	PT (Ltd.)	Risalah Ummat	Mrz 96	Mai 96	Tangerang	Banten
43	PT (Ltd.)	Bina Rahmah	Sep 96	Okt 96	Bogor	Jawa Barat
44	PT (Ltd.)	Insani	Okt 96	Okt 96	Tangerang	Banten
45	PT (Ltd.)	Ariyah Jaya	Okt 96	Okt 96	Depok	Jawa Barat

46	PT (Ltd.)	Amanah Insani	Okt 97	Okt 97	Bekasi	Jawa Barat
47	PT (Ltd.)	Rif'atul Ummah	Feb 98	Mai 98	Bogor	Jawa Barat
48	PT (Ltd.)	Insan Cita Artha Jaya	Feb 98	Feb 98	Bogor	Jawa Barat
49	PT (Ltd.)	Berkah Ramadhan	Mrz 02	Apr 02	Tangerang	Banten
50	PT (Ltd.)	Al Mabrrur Babadan	Nov 00	Jan 01	Ponorogo	Jawa Timur
51	PT (Ltd.)	Rahman Hijrah Agung	Dez 95	Dez 95	Aceh Utara	Nanggroe Aceh Darussalam
52	PT (Ltd.)	Bhakti Haji Malang	Dez 95	Mrz 96	Malang	Jawa Timur
53	PT (Ltd.)	Daya Artha Mentari	Mrz 96	Mrz 96	Pasuruan	Jawa Timur
54	PT (Ltd.)	Al Hidayah	Mai 99	Jun 99	Pasuruan	Jawa Timur
55	Koperasi (Cooperation)	Untung Surapati	Aug 01	Sep 01	Pasuruan	Jawa Timur
56	PT (Ltd.)	Tulen Amanah	Mrz 93	Mrz 93	Lombok Timur	Nusa Tenggara Barat
57	PT (Ltd.)	Patuh Beramal	Feb 94	Feb 94	Mataram	Nusa Tenggara Barat
58	PT (Ltd.)	Kafalatih Ummah	Jun 94	Jul 94	Deli Serdang	Sumatera Utara
59	PT (Ltd.)	Al Washliyah	Sep 94	Nov 94	Deli Serdang	Sumatera Utara
60	PT (Ltd.)	Gebu Prima	Feb 96	Mrz 96	Medan	Sumatera Utara
61	PT (Ltd.)	Puduarta Insani	Apr 96	Jun 96	Deli Serdang	Sumatera Utara
62	PT (Ltd.)	Mentari Pasaman Saiyo	Mai 96	Jul 96	Pasaman	Sumatera Barat
63	PT (Ltd.)	Carana Kiat Andalas	Mai 97	Jun 97	Agam	Sumatera Barat
64	PT (Ltd.)	Ampek Angkek Candung	Mai 99	Jul 99	Agam	Sumatera Barat
65	PT (Ltd.)	Al Falah	Dez 94	Jan 95	Musi Banyuasin	Sumatera Selatan
66	PT (Ltd.)	Hasanah	Jan 95	Apr 95	Bengkalis	Riau
67	PT (Ltd.)	Berkah Dana Fadhilah	Jun 96	Jun 96	Kampar	Riau
68	PT (Ltd.)	Amanah Bangsa	Jul 94	Sep 94	Simalungun	Sumatera Utara
69	PT (Ltd.)	Sabiilul Muttaqin	Okt 96	Jan 97	Banyumas	Jawa Tengah
70	PT (Ltd.)	Ikhsanul Amal	Aug 95	Aug 95	Kebumen	Jawa Tengah
71	PT (Ltd.)	Asad Alif	Aug 98	Sep 98	Kendal	Jawa Tengah
72	PT (Ltd.)	Bakti Makmur Indah	Feb 94	Apr 94	Sidoarjo	Jawa Timur
73	PT (Ltd.)	Amanah Sejahtera	Dez 95	Jan 96	Gresik	Jawa Timur
74	PT (Ltd.)	Al Wadi'ah	Sep 94	Dez 94	Tasikmalaya	Jawa Barat
75	PT (Ltd.)	Ikhwanul Ummah	Apr 93	Apr 93	Ujung Pandang	Sulawesi Selatan
76	PT (Ltd.)	Matahari Ufuk Timur	Jun 94	Jun 94	Maros	Sulawesi Selatan
77	PT (Ltd.)	Sinar Surya Sejati Palleko	Jul 94	Aug 94	Takalar	Sulawesi Selatan
78	PT (Ltd.)	Niaga Madani	Okt 94	Dez 94	Pinrang	Sulawesi Selatan
79	PT (Ltd.)	Nurul Ikhwan	Jun 95	Jun 95	Polewah Mamasa	Sulawesi Selatan
80	PT (Ltd.)	Gowata	Sep 97	Dez 97	Gowa	Sulawesi Selatan
81	PT (Ltd.)	Margirizki Bahagia	Nov 93	Jan 94	Bantul	Yogyakarta
82	PT (Ltd.)	Bangun Drajat Warga	Nov 93	Feb 94	Bantul	Yogyakarta
83	PT (Ltd.)	Ittihad	Apr 02	Jun 02	Wajo	Sulawesi Selatan
84	PT (Ltd.)	Bumi Rinjani Batu	Nov 02	Jan 03	Batu	Jawa Timur
85	PT (Ltd.)	Bumi Rinjani Malang	Nov 02	Jan 03	Malang	Jawa Timur
86	PT (Ltd.)	Cilegon Mandiri	Apr 03	Mai 03	Cilegon	Banten
87	PT (Ltd.)	Buana Mitra Perwira	Jun 04	Jun 04	Purbalingga	Jawa Tengah
88	PD (Local Govt. Co.)	Tanggungus	Mai 04	Jun 04	Tanggungus	Lampung
89	PT (Ltd.)	Artha Surya Barokah	Jun 04		Semarang	Jawa Tengah
90	PT (Ltd.)	Situbondo	Mrz 04		Situbondo	Jawa Timur

Appendix 1: Financial infrastructure

Indonesia has one of the most differentiated banking and microfinance sectors of any developing country. After more than a hundred years of evolutionary growth, the banking sector as of 2003 comprised:

- 138 commercial banks
- with a total of 7,730 bank offices if 4,049 BRI rural units are excluded and 11,779 if they are included
- 2,134 rural banks (BPR), comprising rural and peri-urban banks

The rural and microfinance sector comprises (Table 1)¹:

- 6,300 formal microfinance units
- 47,200 semiformal microfinance units
- Together, these 53,500 units hold 47 million deposit and 32 million loan accounts
- 800,000 channeling groups
- millions of rotating savings and credit associations (ROSCAs, *arisan*) of indigenous origin.

After the establishment of the first rural bank in 1895, a three-tiered financial system developed rapidly, comprising national, district and village institutions. At the top has been a century-old agricultural bank, now known as Bank Rakyat Indonesia (BRI). At the community level were two types of village banks, specialized on banking-in-kind and banking-in-money. As early as 1910, there were over 13,000 rural banks, comprising 12,542 rice banks (*Lumbung Desa*) and 585 money banks (*Bank Desa*). Since then, money has gradually replaced kind: as of 1940, their numbers had changed to 5,451 *Lumbung Desa* and 7,443 *Bank Desa*. As of 1989 there were 2,056 *Lumbung Desa* and 3,297 *Bank Desa*, lumped together after 1989.² According to a recent ADB study³, the microfinance sector now comprises some 6,000 formal and 48,000 semiformal microfinance institutional outlets (MFIs), serving about 45 million depositors⁴ and around 32 million borrowers. (Table 1)⁵ Among them, the BRI Units (formerly *unit desa*) - presumably the developing world's most successful rural microfinance providers - account for 74% of microsavings and 39% of microloans. Outside the formal and semiformal institutional sector are some 800,000 channeling groups and the ubiquitous rotating savings association (*arisan*), numbering in the millions, as grassroots institutions of most of the poor and non-poor. New efforts have been made to extend the protection of the law to financial institutions of the poor and near-poor by preparing in 2001 a draft law for MFIs (*Lembaga Keuangan Mikro, LKM*).⁶ Despite the extraordinarily high level of institutional differentiation, large numbers of households are reported to remain without access to formal and semiformal finance.

¹ These institutions are predominantly rural and peri-urban. The figures differ widely according to source. Eg, Holloh (2001:33) lists a total of 93,700 outlets. A number of institutions with outreach into rural microfinance are not included here, among them private national and regional commercial banks and regional government-owned development banks (BPD).

² D. Steinwand, *The Alchemy of Microfinance*. Berlin: FWF 2001:172; D. Holloh, *Microfinance Institutions Study*. Jakarta: MoF, BI, GTZ 2001; H. D. Seibel, *Finance with the Poor, by the Poor, for the Poor: Financial Technologies for the Informal Sector, With Case Studies from Indonesia*. Social Strategies vol. 3, no. 2 (Dec. 1989: 3-47).

³ ADB Rural Microfinance Indonesia (TA No. 3810-INO), March 2003, Annex 4

⁴ Recorded here is the number of deposit accounts, the number of actual depositors is lower.

⁵ These institutions are predominantly rural and peri-urban. The figures may differ widely according to source. Eg, Holloh (2001:33) lists a total of 93,700 outlets. A number of institutions with a partial outreach into rural microfinance are not included here, among them private national and regional commercial banks and regional government-owned development banks (BPD).

⁶ Act XXX of 2001, draft dated 14/9/2001. This is a participatory effort coordinated by a Tim Inisiatif, first headed by Bank Indonesia and now by a newly created microfinance unit in the MoA. World Bank, ADB and GTZ are involved.

Table 1: Number and outreach of formal and semiformal MFIs (BRI, BPR and BKD Dec. 2003, others ~2000) (amounts in billion Rupiah)

	Units***	Deposit accounts		Deposit volume		Loan accounts		Loans outstanding		
		In '000	%	Rp bn	%	In '000	%	Rp bn	%	Av. loan Rp
Banks										
BRI Microbanking Div.	4,049	29,859	64	27,420	80	3,100	10	14,183	54	4,575,000
Rural banks BPR ~2000	2,213	4,698	10	5,066	15	1,745	5	5,628	21	3,225,000
Rural banks Dec. 2003**	2,134	5,535		8,868		1,993		8,985		4,508,000
Financial cooperatives*	40,527	11,043	24	1,659	5	11,093	34	4,787	18	431,500
Unit Simpan Pinjam (USP) ****	35,218	10,141	23	1,157	4	10,141	31	3,629	18	358
Koperasi Simpan Pinjam (KSP, Sav&Cr. Coop)****	1,123	551	1	151	1	551	2	708	4	1,285
Credit Unions (CU)	1,071	296	Nil	249	1	296	1	272	1	920
BMT	2,938		Nil	46	Nil	73	0	51	0	701
Swamitra/BUKOPIN	177	55	Nil	56	Nil	32	0	127	1	3,960
Non-bank financial institutions										
Village MFIs (BKD)	4,482	535	1	24	0	414	1	193	1	466,000
Other MFIs (LDKP)	1,428	834	2	218	1	419	1	328	1	783,000
Pawnshops	772	0	0	0	0	15,692	48	1,355	5	86,000
Total all institutions*	53,471	46,969	101	34,387	101	32,463	99	26,474	100	815,500

* Errors in percentage totals due to rounding.

** Figures on BPR on the BI website differ by ~2%.

*** The term *units* is not uniformly applied. Eg, in the case of the BRI Microbanking Division, it refers to outlets including cash offices of the *unit desa* (now: *unit unit*); in the case of BPR it refers to banks and excludes their branches.

**** USP & KSP together as of 2003: 40,639

Sources: BI 2003; BI BPR reporting; BRI Microbanking Division Monthly Report; ADB Rural Microfinance Indonesia (TA No. 3810-INO), Draft report March 2003, Annex 4, p. 2.

The banking law in Indonesia recognized two types of banks: commercial banks (*Bank Umum, BU*, lit.: universal banks) and rural banks (Bank Perkreditan Rakyat, BPR, lit.: people's credit banks).

The commercial banking sector, which nearly collapsed during the 1997/98 crisis, has greatly recovered due to major consolidation efforts of the government, including numerous bank closures and mergers. From 1999 to 2003, the gross non-performing loan ratio (NPL) went down from 32.8% to 8.1% and net NPL from 7.3% to 1.8%. During the same period, the banks went from losses (Rp 75.4tr, or 7.5% of total assets as of December 1999) to (pre-tax) profits of Rp 23.7tr, or 2.1% of total assets as of November 2003; similarly capital adequacy (CAR) went from -8.1% in 1999 to 20.7% in 2003. However, overall growth of the commercial banking sector was sluggish: From December 2000 to November 2003, total assets grew in nominal terms by 10.8% from Rp 1,030.5tr to Rp 1,142.2tr; third-party funds (including savings and deposits) by 25.2% from Rp. 699,1tr to Rp 875.4tr; and credit by 48.5% from Rp 320.4tr to Rp 475.7tr .

Rural banks (BPR) according to the law of 1988 (*PAKTO27*) consist of newly established BPR (*BPR baru*) and pre-existing rural banks converted into BPR (*BPR lama*). In the context of financial liberalization, the law was enacted in an effort to rationalize the highly complex rural finance sector, with the objective of bringing existing institutions under the umbrella of prudential regulation and supervision, providing a framework for the establishment of new financial institutions with private capital, and extending the outreach of financial institutions to

the poorer sections of the rural and peri-urban population, thereby lessening their dependence on private moneylenders. Minimum capital requirements for BPR were uniformly set at Rp 50m, equivalent to US\$ 29,000 in 1988, \$24,000 in 1992 and \$21,000 in 1996. Most of the newly established BPR were set up by private owners.

There are now (Dec.2003) 2134 licensed and regulated BPR. While they account for a mere 1.0% of total banking assets their growth during the last three years as been far more rapidly than that the commercial banking sector (*see below*).

Table 1.2: Basic data on rural banks (BPR), 2000-2003 (amounts in trillion Rupiah)

<i>Year</i>	<i>Number</i>	<i>Total assets</i>	<i>Credit</i>	<i>Savings (tabungan)</i>	<i>Deposits (deposito)</i>	<i>Savings & deposits</i>	<i>Paid-in capital</i>
2000	2,419	4.99	3.78	1.20	1.89	3.09	1.09
2001	2,355	6.75	5.04	1.59	2.71	4.30	1.49
2002	2141	9.34	6.86	2.02	4.12	6.14	1.91
2003	2134	12.90	9.18	2.64	6.25	8.89	2.41

Source: http://www.bi.go.id/bank_indonesia_english/main/statistics/. Figures may differ from BI written reports, which reflect various stages of updating.

Appendix 2 Table 1: Development of conventional and Islamic rural banks in Indonesia, 1993-2003

Million IDR

	Dec'93	Dec'94	Dec'95	Dec'96	Dec'97	Mar'98	June'98	Sept'98	Dec'98	Dec'99	Dec'00	Dec'01	Dec'02	Dec'03
1. Number of banks														
Total RBs	1709	1873	1948	1987	2140	2186	2227	2262	2262	2427	2419	2355	2141	2134
IRBs	22	46	57	71	75	77	77	78	78	79	80	81	83	84
Share IRBs to Total	1.3	2.5	2.9	3.6	3.5	3.5	3.5	3.4	3.4	3.3	3.3	3.4	3.9	3.9
2. Loans (Million Rp)														
Total RBs	1195868	1476001	1790193	2036205	2172515	2090393	1965230	1875365	1860595	2451593	3618927	5040000	6860000	9180000
IRBs	7380	19952	28737	39008	43330	51780	50500	51246	53502	57306	82326	110026	119206	138561
Share IRBs to Total	0.6	1.4	1.6	1.9	2.0	2.5	2.6	2.7	2.9	2.3	2.3	2.2	1.7	1.5
3. Deposits (Million Rp)														
Total RBs	993264	1207102	1385072	1554250	1576369	1587413	1513163	1489786	1470112	2038132	3081718	4300000	6140000	8890000
IRBs	6118	17654	24226	32513	33160	36061	32905	33683	35550	44067	62512	91417	97512	109999
Share IRBs to Total	0.6	1.5	1.7	2.1	2.1	2.3	2.2	2.3	2.4	2.2	2.0	2.1	1.6	1.2
4. Total assets (Million Rp)														
Total RBs	1566097	1900225	2253478	2574164	2735708	2745066	2696384	2688719	2751415	3462031	4731240	6750000	9340000	12900000
IRBs	11778	30369	43024	50571	60135	73027	70858	73627	80579	86783	113096	153321	165046	191750
Share IRBs to Total	0.8	1.6	1.9	2.0	2.2	2.7	2.6	2.7	2.9	2.5	2.4	2.3	1.8	1.5

* Number of BPRS by Dec. 2001: 4; Dec. 2002: 9

Note: **Double-click** on table to show column Dec'03 on screen

Appendix 2 Table 2: Development of Islamic Rural Banks, 1993-2003

Million IDR

	Dec'93	Dec'94	Dec'95	Dec'96	Dec'97	Dec'98	Dec'99	Dec'00	Dec'01	Dec'02	Dec'03
Financing	7380	19952	28737	39008	43330	53502	57306	82326	110026	119206	138561
Deposits	6118	17654	24226	32513	33160	35550	44067	62512	91417	97512	109999
Total Assets	11778	30369	43024	50571	60135	80579	86783	113096	153321	165046	191750
Number of Banks	22	46	57	71	75	78	79	80	81	83	84

Source: Islamic Banking Directorate-Bank Indonesia

Appendix 3: Evolution and Structure of Islamic Finance in Indonesia

Table 1: Total assets of commercial and rural banks by conventional and Islamic banking type, 2003 (in trillion Rupiah)

Banking sector	Conventional		Islamic		Total	
	Amount	Percent	Amount	Percent	Amount	Percent
Commercial (BU)	1,060.5	98.8	7.86	97.6	1,068.4	98.8
Rural (BPR)	12.7	1.2	0.19	2.4	12.9	1.2
Total banking sector	1,073.2	100.0	8.05	100.0	1,081.3	100.0

Table 2: Basic data of the commercial banking sector and Sharia-based commercial banks, Dec. 2003 (amounts in trillion Rupiah)

Selected consolidated balance sheet items	Total commercial banking sector (amount)	Islamic commercial banks	
		Amount	Percent
Total assets	1068.4	7.86	0.74
Deposits	888.6	5.72	0.64
Loans/financing outstanding	477.2	5.53	1.16
<i>Ratios</i>	<i>Total commercial banking sector</i>	<i>Islamic commercial banks</i>	
LDR, FDR*	53.7%	96.6 %	
Non-performing loans	8.2%	2.3 %	

Source: BI 1/2004:13

* Loans-to-deposit ratio, financing-to-deposit-ratio

Table 3: Capital adequacy ratios and returns on assets in Islamic banks, 2000-2003

	2000	2001	2002	Nov. 2003
CAR of Islamic commercial banks	53.4	30.8	21.5	20.3
CAR of Islamic commercial banking units	23.7	19.9	36.5	32.8
ROA		1.2	0.8	0.6

Source: BI 2003:128

Table 4: Deposits and loans by Islamic commercial banks and banking units, Dec. 2003

Deposits	
Wadiah current accounts	11.1%
Mudrabah savings accounts	28.1%
Mudrabah time deposits	60.7%
Total percent	99.9%
Total amount	Rp 5.72tr
Percent of total liabilities and equity	72.8%

Table 5: Financings by Islamic commercial banks and banking units, Dec. 2003

Financings	
Musharaka financings	5.5%
Mudrabah financings	14.4%
Murabahah receivables	71.5%
Istishna' receivables	5.4%
Other	3.2%
Total percent	100%
Total amount	Rp. 5.53tr
Percent of total assets	70.4%

Appendix 4: Islamic rural banks (BPRS)

Table 1: Regional distribution of BPRS, June 2004

Province	Licensed BPRS		License revoked
	Number	Percent	
Java:	53	61.6	4
West Java	25		3
Banten	10		1
Central Java	5		
D.I. Yogyakarta	2		
East Java	11		
Sumatra:	20	23.3	
Nangroe Aceh Dar.	5		
North Sumatra	5		
West Sumatra	3		
South Sumatra	1		
Lampung	3		
Bangkulu	1		
Riau	2		
Sulawesi:	7	8.1	
South Sulawesi	7		
Kalimantan:	2	2.3	
East Kalimantan	1		
South Kalimantan	1		
Bali:	1	1.2	
West Nusa Tenggara:	2	2.3	
Papua:	1	1.2	
Total licensed BPRS	86	100.0	
Revoked licenses			4
Total BPRS			90

Table 2: Year of origin, ownership and number of board members in 5 sample BPRS

BPRS	Year of origin	No. of owners	Owners	No of board members
1 Alwadi'ah	1994	3	Private individuals	9
2 Artha Fis.	1994	9	Private individuals	10
3 Harum Hik.	1994	25	3 ind. + 22 employees	7
4 Wakalumi	1990/1994	118	Private individuals	7
5 Bangka	1995	3	2 foundations, local gvt.	8

Table 3: Number of delivery units, number of staff and service radius in five sample BPRS

BPRS	Number of units (incl. head-office)	Number of staff	Loan officers		Service radius in km
			Number	% of staff	
1 Alwadi'ah	2	18	12		30
2 Artha Fis.	1	11	6		20
3 Harum Hik.	5	22	12		50
4 Wakalumi	5	38	13		40
5 Bangka	2	18	9		50
Average (mean)	3	21.4	10.4	48.6	38

Table 4: Number of borrowers in four sample BPRS

<i>BPRS</i>	<i>Total no. of borrowers</i>
1 Alwadi'ah	800
2 Artha Fis.	163
3 Harum Hik.	800
4 Wakalumi	2000
5 Bangka	664
Average (mean)	885

Table 5: Number of clients by occupation, sex and poverty category in four sample BPRS

<i>BPRS</i>	<i>Total no. of clients</i>	<i>% small traders & microentrepreneurs</i>	<i>% farmers</i>	<i>% salaried</i>	<i>% women</i>	<i>% below poverty line</i>
1 Alwadi'ah	4000	89	3	8	30	20
2 Artha Fis.	1150	90	1	9	0	0
3 Harum Hik.	6000	63	9	23	45	3
4 Wakalumi	5000	95	0	5	*	0
5 Bangka	1722	59	2	39	35	3
Unweighted mean	3574	79	3	17	28	5

* Both husband and wife have to sign the loan contract.

Table 6: Total assets of five sample BPRS

<i>BPRS</i>	<i>Total assets in mn</i>
1 Alwadi'ah	6,951
2 Artha Fis.	1,404
3 Harum Hik.	6,887
4 Wakalumi	12,554
5 Bangka	7,689
Average (mean)	7,097
Mean of 84 BPRS	2,283

Table 7: Liabilities and equity of 84 BPRS, Dec. 2003

Source of funds	Amount in Rp million	Percent
Current accounts	1,690.9	0.9
Deposits	109,998.9	57.4
Savings	58,574.1	
Time deposits	51,424.8	
Bank deposits	22,083.2	11.5
Bank Indonesia	1,167.9	
Other banks	20,915.3	
Borrowings	7,237.9	3.8
Subordinated loans	3.1	
Other loans	7,234.8	
Other liabilities	6,753.9	3.5
Equity:	43,985.5	22.9
Paid-up capital	31,004.3	
Other capital	6,586.6	
Reserves	3,715.0	
Profit of previous year	1,435.5	
Profit of current year	1,244.1	
Total liabilities and equity	191,750.2*	100.0

*Error due to rounding

Table 8: Deposits of BPRS and BPR in percent of total assets and loans outstanding, Dec. 2003

	BPRS	Conventional BPR	BPR
Average deposits in Rp bn	4.17	4.28	4.17
Deposits in % of total assets	57.4	69.1	68.9
Deposits in % of loans outstanding	79.4	97.1	96.8

Table 9: Savings and time deposits in the BPRS sector and in five sample BPRS, Dec. 2003

BPRS	Total deposits in mn	% savings	% time deposits
1 Alwadi'ah	4,109.0	59.2	40.8
2 Artha Fis.	619.2	75.8	24.2
3 Harum Hik.	4,017.7	34.9	65.1
4 Wakalumi	6,039.9	43.0	57.0
5 Bangka	5,621.5	35.6	64.4
Mean of 84 BPRS	109,998.9	53.2	46.8

Table 10: Deposit products in five sample BPRS

BPRS	Total amount (in million Rp)	Number of products	Savings accounts*		Time deposits*	
			Revenue-sharing Client-Bank	Average return in % p.a.	Revenue-sharing Client-Bank	Return in % p.a.
1 Alwadi'ah	3,796	4	50:50	6%	70:30	10%
2 Artha Fis.	619	4	30:70	12%	40:60	18%
3 Harum Hik.	4,018	3	40:60	8.8%	65:35	14%
4 Wakalumi	6040	12	35:65	7.09	56:44 to 66:34	11.35 to 13.37
5 Bangka	5,622	n.a.	40:60	7.5%	55:45	11.5%
Mean	4,019	5.75	40:60	8.3%	60:50	13%

*By comparison, BMI, an Islamic commercial bank, reports yields to depositors of 6-7% p.a. on savings accounts and 7-9% on term deposits.

Table 11: Loan products in five sample BPRS⁷

BPRS	Amount (in mn Rp)	No. of accounts	No. of products	Loan products in % of portfolio			
				Murabahah	Musyarakah	Mudarabah	Other
1 Alwadi'ah	5,694.4	800	3	60	40		
2 Artha Fis.	1,208.0	163	4	85			15
3 Harum Hik.	4,312.7	800	1	100			
4 Wakalumi	9,652.8	2000	4	93	5	0.5	1
5 Bangka	4,562.8	n.a.	2	90		10	
Unweighted mean	5,086.1	941	2,8	86	9	2	3

The five sample BPRS have on average Rp 5.1bn in financings or loans outstanding, with an average of Rp 5.4mn per borrower. They have from one to four loan products. The main product found in every bank is Murabahah, ie, a sales contract between bank and customer with a mutually agreed-upon fixed profit margin for the bank; this accounts for 86% of the unweighted average loan volume. Three of the banks have a Mudarabah or a Musyarakah product, with profit-sharing between the bank and one or several business partners, respectively, accounting together for 11 % of financings. Other products are of no or minor significance: BPRS Alwadi'ah lists Qard al-Hasanah for the very poor among its products, where the bank bears the full risk but receives no remuneration, but has in fact no borrowers.⁸ BPRS Artha Fisabilillah includes consumer lending to salary earners among its products with a 15% share, which does not fall under the classical Islamic financing products; it also offers Musyarakah and Mudarabah financing, but its customers have not yet accepted this product. BPRS Wakalumi has a small Al-Ijarah or leasing portfolio.

Murabahah, based on the principle of a sales contract with a fixed profit margin for the bank, is the main financing product, with a share of 90-100% in three of the five banks and an overall unweighted share of 86%. With its fixed mark-up (similar to an interest rate), it is better understood by the borrowers and easier to handle by the bank. The mark-ups are generally flat rates, which is common in Indonesia: Customers pay a fixed and equal amount per month while repaying in monthly or weekly instalments. The effective mark-up per annum varies by instalment schedule and maturity; as a rule of thumb, the effective interest rate p.a. is approximately twice the flat rate, assuming equal monthly instalments over a repayment period of one year. In addition, there is frequently an up-front administrative fee, mostly of 1%. Of the five sample BPRS, only BPRS Wakalumi charges a mark-up on the declining balance; the others charge flat rates. **Effective annual mark-ups or profit margins** of the five banks are approximately 55% p.a., ranging from a low of 38.5% by the largest to a high of 66% by the smallest of the five banks, assuming average maturities of one year; as actual maturities vary from 6-36 months, effective rates can be substantially lower or higher, respectively.⁹ There are no penalties for late payment in the five banks, which means that effective mark-ups or interest rates go down as payments are delayed.¹⁰ By comparison, the interest rates of the BRI units are 2% flat per month or approximately 43% effective p.a. The interest rate is reduced to 1.5% flat per month or 33% effective p.a. for customers who pay on time. BPR generally have lower efficiencies and higher interest rates than BRI units.

Musyarakah and Mudarabah financings tend to be larger in volume: either at the same mark-up as Murabahah as in BPRS Wakalumi, or at almost half the rate as in BPRS Alwadi'ah.

Loan sizes start as low as Rp 0.5m, 1.0m and Rp 3m (US\$ 60-360), respectively, and go up to Rp 50m, 75, 100m or 150m, respectively. Maturities among the five banks are from 1-36 months.

Instalments are mostly monthly; but one bank offers daily instalments through a collector, while another one permits daily, weekly, monthly or quarterly instalments. All loans are collateralised. Two of

⁷ By comparison, financings of BMI, the oldest and largest Islamic commercial bank with a loan portfolio of Rp. 2.25tr, are distributed product-wise as follows: Murabahah 53.5%; Mudharabah 34.6% Musyarakah 1.6%, other 10.3%.

⁸ BMI also reports the existence of this product; but the amount is insignificant. No mark-up or profit-share is included; but beneficiaries pay an administrative fee of 1%. Maturities are 1-2 years. Qard loans are mainly given to employees, eg, to rent a house, for educational and social purposes.

⁹ By comparison, BMI charges margins of 15.5% eff. p.a. for 1st year; 0.5% are added for every additional year (up to 18.5% in the 7th year, the longest period of financing) on Murabahah financings.

¹⁰ By comparison, charges no penalties on late payments, but a so-called administrative fee (stated in terms of a nominal amount, approx. 1% of amount overdue per month) which cannot be claimed as income and is allocated to a social fund.

the five banks require a savings deposit of at least 5%. Loan supervision is reportedly tight, implemented through frequent visits by loan officers or collectors.

Table 12: Non-performing loans, return on average assets and return on year-end assets in five sample BPRS (in %), 2003

BPRS	NPL	ROAA	ROA (yr-end)
1 Alwadi'ah	n.a.	2.0	1.5
2 Artha Fis.	4.5	2.3	2.4
3 Harum Hik.	3.0	n.a.	5.7
4 Wakalumi	11	3.35	2.1
5 Bangka	0	5.0	3.2
BRI units	2.5	5.7	

Table 5.13: Balance sheet, income statement and performance ratios of BPRS Artha Fisabilillah, 201-2003

Amounts in Rp million

	2001	2002	2003
Balance sheet			
Activa:			
<i>Cash at hand</i> Kas	168	118	101
<i>Gross loans/facilities outstanding</i> Pembiayaan yang diberikan kotor	910	785	1,208
<i>./. Loan loss reserve</i> <i>./. Penyisihan Penghapusan</i>	43	65	4
<i>= Net loans/facilities outstanding</i> <i>= Pembiayaan yg diberikan bersih</i>	867	720	1,204
<i>Net fixed assets</i> Aktiva tetap setelah dikurangi	21	19	14
<i>Other net assets</i> Aktiva lain-lain Bersih	89	106	85
Total assets Jumlah aktiva	1,145	963	1,404
Passiva:			
<i>Savings and deposits of clients</i> Simpanan	619	549	619
<i>Borrowings</i> Pinjaman	100	0	338
<i>Other liabilities</i> Kewajiban lain-lain	4	0	14
Total liabilities Jumlah kewajiban	723	549	971
<i>Paid-up capital</i> Modal ditempatkan dan disetor penuh	387	387	387
<i>Profit of past and current years</i> Laba tahun berjalan	35	27	46
Total equity Jumlah ekuitas	422	414	433
Total liabilities and equity Jumlah kewajiban dan ekuitas	1,145	963	1,404
Income statement			
Gross income from financial operations <i>Pendapatan margin, bagi hasil, provisi, komisi</i>	466	392	400
<i>./. Interest or profit-sharing expenses</i> <i>./. Beban margin dan bagi hasil</i>	(116)	(102)	(109)
<i>= Net income from financial operations</i>	350	290	291

	= Jumlah pendapatan marjin dan bagi hasil			
	+ Other operational income + Jumlah pendapatan operasional lainnya	63	44	48
	./. Other operational expenses ./. Jumlah beban operasional lainnya	(385)	(314)	(305)
	Personnel expenses in % Beban personalia di %			
	Loan loss provision (included above) Penyusutan dan penyisihan (di dalam)	137	45	14
	= Operational profit = Laba operasional	29*	30	34
	./. Non-operational expenses ./. Beban non-operasional	(2)	0	(1)
	= Profit (loss) = Jumlah laba (rugi)	27*	30	33*

* Error due to rounding

Performance	2001	2002	2003
Loan recovery			
NPL, NPF in %	9.6	19.8	4.5
Loan Loss Ratio in %	8.9	18.7	6.25
Profitability			
Return on average assets in %	2.3	1.7	2.4
Return on average equity in %	7.0	4.3	8.75
Ratios			
Equity/liabilities in %	58.4	75.4	44.6
Deposits/liabilities in %	85.6	100.0	63.7
LDR Loan-to-deposit, FDR Financing-to-deposit ratio in %	147	143	195
CAR Capital adequacy in %	38.7	43.9	31.6

NPL, NPF Non-performing loans; Islamic: Non-performing finance

Loan loss ratio = loans written off to average loans outstanding

Capital adequacy = capital/net loans or net financing

Table 14: Balance sheet, income statement of BPRS Wakalumi, 2002 and 2003

Amounts in Rs million

Balance sheet	2002 (unaudited)	2003 (audited)
Cash at hand Kas	393.2	257.8
Bank deposits Giro, tabungan, deposito pada bank	1,170.8	1,886.4
Gross loans/facilities outstanding Pembiayaan yang diberikan kotor	7,301.1	9,653.8
./. Loan loss reserve	(127.9)	(180.8)
./. Penyisihan Penghapusan = Net loans/facilities outstanding = Pembiayaan yg diberikan bersih	7,173.2	9,473.0
Net fixed assets Aktiva tetap setelah dikurangi	217.2	203.6
Other net assets Aktiva lain-lain Bersih	526.3	733.3
Total assets Jumlah aktiva	9,480.7	12,554.2
Savings and deposits of clients Simpanan	5,038.1	6,039.9
Deposits of banks Simpanan dari bank lain	600.0	1,001.5
Borrowings Pinjaman	1,655.3	3,022.7

<i>Unpaid taxes</i> Hutang pajak	109.1	120.0
<i>Other liabilities</i> Kewajiban lain-lain	83.8	131.3
Total liabilities Jumlah kewajiban	7,488.9	10,318.0
<i>Paid-up capital</i> Modal ditempatkan dan disetor penuh	1,494.5	1,521.5
<i>Earnings (retained and current)</i> Laba (tahun lalu dan berjalan)	497.3	714.8
Total equity Jumlah ekuitas	1,991.8	2,236.3
Total liabilities and equity Jumlah kewajiban dan ekuitas	9,480.7	12,554.2

Income statement	<i>Rs. Million</i>
Gross income from financial operations Pendapatan margin, bagi hasil, provisi, komisi	2,231.8
<i>./. Interest or profit-sharing expenses</i> <i>./. Beban margin dan bagi hasil</i>	(861.4)
= Net income from financial operations = <i>Jumlah pendapatan margin dan bagi hasil</i>	1,370.4
+ Other operational income + <i>Jumlah pendapatan operasional lainnya</i>	161.8
<i>./. Other operational expenses</i> <i>./. Jumlah beban operasional lainnya</i>	1,157.8
Personnel expenses in % <i>Beban personalia di %</i>	53.9%
Loan loss provision (included above) <i>Penyusutan dan penyisihan (di dalam)</i>	(126.9)
= Operational profit = <i>Laba operasional</i>	374.4
<i>./. Non-operational expenses</i> <i>./. Beban non-operasional</i>	7.7
= Gross profit (loss) = <i>Jumlah laba (rugi)</i>	366.7
<i>./. Religious tax</i> <i>./. Zakat</i>	9.0
<i>./. Other expenses</i> <i>./. Beban pajak penghasilan</i>	89.8
Net profit (loss) <i>Laba bersih (rugi)</i>	267.9

Performance	2001	2002	2003
Loan recovery			
NPL, NPF in %			11
Loans written off in million Rp	0	0	5m
Loan Loss Ratio in %	0	0	3
Profitability			
Return on average assets in %	4.07	3.65	3.35
Return on average equity in %	20.32	21.05	24.10
Ratios	2001	2002	2003
Equity/liabilities in %		26.6	21.7
Deposits/liabilities in %		67.3	58.5
LDR Loan-to-deposit, FDR Financing-to-deposit ratio in %	85.32	88.58	86.72
CAR Capital adequacy in %	22.99	21.74	20.86
OCR BOPO Operational costs-to-revenue	82.79	86.50	84.71

Appendix 5: Islamic cooperatives

Table 1: Financial cooperatives as part of the microfinance sector*

	<i>Units</i>	<i>Deposit accounts in '000</i>	<i>Deposit volume in Rp bn</i>	<i>Loan accounts in '000</i>	<i>Loans outstanding in Rp bn</i>
Total MFIs	53,471	46,969	34,387	32,463	26,474
Rural banks (Dec. 2003)	2,134	5,535	8,868	1,993	8,985
Financial cooperatives	40,527	11,043	1,659	11,093	4,787
Financial cooperatives in % of all MFIs	75.8%	23.5%	4.8%	34.2%	18.1%
Financial cooperatives in % of MFIs excl. BRI units	82.0%	64.5%	23.8%	37.8%	38.9%

* Adapted from App. 1 Table 1

Table 2: Basic data of KSP/USP, December 2002 and December 2003

	KSP/USP sector 2002	KSP/USP sector 2003	Mean per KSP/USP 2003
Number of KSP/USP	36,532	36,376	
Number of members:	10,514,624	10,420,582	286
Total assets	6,792.7 billion Rp	6,197.1 billion Rp	170.4 million Rp
Loans outstanding	5,551.3 billion Rp	5,273.6 billion Rp	145.0 million Rp
Deposits	1,500.8 billion Rp	1,593.4 billion Rp	43.8 million Rp

Source: Ministry of Cooperatives, Perkembangan KSP/USP Koperasi Seluruh Indonesia, 2004

Table 3: Year of origin, members and number of board members in four BMT

<i>BMT</i>	<i>Year of origin and registration</i>	<i>No. of members</i>	<i>No of board members</i>
1 At-Taqwa	1994/2000	4000	14
2 Ibaadurrahman	1992/1992	3000	3
3 Latanza	1996/2000	800 in 80 SHGs 20 SHGs active as borrowers 60 saving groups only	8
4 Wira Mandiri	1997/1999	45 voting members; 2000 partnership without voting rights	4

Table 4: Regional distribution of BMT, 2001 and 2003*

<i>Province</i>	<i>BMT 2001</i>		<i>BMT 2003</i>		<i>KSP/USP Percent</i>
	<i>Number</i>	<i>Percent</i>	<i>Number</i>	<i>Percent</i>	
Java:	1980	65.2	1705	59.7	54.1
Jakarta	165		110		
West Java + Banten	637		494		
Central Java	513		539		
D.I. Yogyakarta	65		76		
East Java	600		486		
Sumatra:	496	16.3	572	20.0	17.6
Nangroe Aceh Dar.	76		76		
North Sumatra	156		199		
West Sumatra	60		60		
South Sumatra	65		70		
Lampung	42		43		
Bengkulu	20		20		
Riau	65		92		
Jambi	12		12		
Kep. Bangka Bel.	0		0		

Sulawesi:		340	11.2	357	12.5	9.2
	North Sulawesi	62		62		
	Central Sulawesi	11		11		
	Sulawesi Tenggara	23		23		
	South Sulawesi	244		261		
	Gorontalo	0		0		
Kalimantan:		66	2.2	66	2.3	10.2
	West Kalimantan	15		15		
	Central Kalimantan	10		10		
	East Kalimantan	24		24		
	South Kalimantan	17		17		
Bali:		15	0.5	15	0.5	2.7
West Nusa Tenggara (NTB)		93	3.1	93	3.3	2.1
East Nusa Tenggara (NTT)		8	0.3	8	0.3	1.7
Maluku + Maluku Utara		21	0.7	21	0.7	1.2
Papua:		18	0.6	19	0.7	1.2
Total number		3037		2856		40,639
Total percent			100.1**		100.0	100%
<i>Change 2001-2003</i>				-6.0%		

*Source: (a) BMT: PINBUK statistics for Dec. 2001, manually corrected for Dec. 2003

(b) KSUP/USP: Ministry of Cooperatives, Rekapitulasi Pemetaan KSP/USP, 13 Apr 2004

** Error due to rounding

Table 5: Number of staff, loan officers and service radius in four BMT

<i>BMT</i>	<i>Number of staff</i>	<i>Loan officers</i>		<i>Service radius in km</i>
		<i>Number</i>	<i>% of staff</i>	
1 At-Taqwa	10	5	50	20
2 Ibaadurrahman	9	2 loan officers + 4 collectors	67	5
3 Latansa	4	2	50	10
4 Wira Mandiri	5	2	40	20
Average (mean)	7	3.75	40	13,75

Table 6: Composition of clientele of four BMT

<i>BMT</i>	<i>Total no. of clients</i>	<i>% small traders & microentrepreneurs</i>	<i>% farmers</i>	<i>% salaried</i>	<i>% other:</i>	<i>% women</i>	<i>% below poverty line</i>
1 At-Taqwa	4000	99	0	1	0	45	60
2 Ibaadurrahman	2500	100	0	0	0	50	70
3 Latansa	800	100	0	0	0	40	30
4 Wira Mandiri	2000	85	5	10	0	30	20
Average	2325	96	1	3	0	41	45

Table 7: Number of borrowers in 4 sample BMT

<i>BMT</i>	<i>Total no. of borrowers</i>
1 At-Taqwa	500
2 Ibaadurrahman	300
3 Latansa	200
4 Wira Mandiri	308
Average	327

Table 8: BMT by asset category, 2001

Asset category	Number	Percent
> Rp 1 billion	63	2.1
Rp 500 million – 1 billion	223	7.3
Rp 250 – 500 million	1202	39.6
Rp 50 – 250 million	1260	41.5
Rp < 50 million	289	9.5
<i>Total</i>	<i>3037</i>	<i>100.0</i>

Table 9: Selected balance sheet data of four BMT (in Rp million)

BMT	Total assets	Gross loan portfolio	Total deposits	FDR in %
1 At-Taqwa	2,211.2	1,819.4	1,957.9	93
2 Ibaadurrahman	341.4	217.2	199.3	109
Latansa	501.1	345.8	137.15	252
4 Wira Mandiri	806.4	587.3	575.8	102
Average (mean)	965.0	742.4	717.5	103

Table 10: Deposit products in four BMT

BMT	Total amount (in million Rp)	Number of products	Savings accounts		Time deposit accounts	
			Revenue- sharing Client-BMT	Average return in % p.a.	Revenue- sharing Client-BMT	Return in % p.a.
At-Taqwa	1,957.9	5	35:65 40:60	9.0 9.6	45:55	13.2
Ibaadurrahman	199.3	4	25:75	5	35:65 40:60 45:55	~12
Latanza	137.15	4	40:60	11	40:60	14-16%
Wira Mandiri	575.8	5		10		14
<i>Mean</i>	<i>717.5</i>	<i>4.5</i>	<i>34:66</i>	<i>8.8</i>	<i>42:58</i>	<i>13.6</i>

Table 11: Loan products in four BMT

BMT	Amount (in mn Rp)	No. of accounts	No. of products	Loan products in % of portfolio			
				Murabahah	Mudarahh	Qard Al-Hassan	Other
At-Taqwa	1,819.4	500	4	70	15	6	10
Ibaadurrahman	217.2	300	2	51	44	2	3
Latanza	345.8	200	2	33	61	6	
Wira Mandiri	587.3	308	4	92	8		0
Unweighted mean	742.4	327	3	61.5	32	3.5	3

Murabahah financings start at amounts of Rp 100,000 in two sample BMTs and Rp 1mn in another two; maximum loan sizes range from 3 to 30 million in the four BMTs. Minimum loan periods range from 1-3 months, maximum loan periods range from 10 to 36 months. Instalments are usually monthly or weekly; BMT Wira Mandiri also allows for daily instalment collection. Mark-ups are negotiated between the BMT and the customer and thus variable, sometimes by a wide margin. Effective mark-ups p.a., comprising a flat rate per month and an up-front administrative fee, range from approximately 38% to 66%; they are mostly above 50% p.a.

Mudarahh financings in the four sample BMT start at loan sizes ranging from Rp 0.1m to 5m; maximum loan sizes range from Rp 5m to 25m. Minimum loan periods range from 1-12 months, maximum loan periods range from 10 to 24 months. Instalments, as in Murabahah, are usually monthly or weekly and also daily in BMT Wira Mandiri. It appears that BMT, unlike BPRS, are unable to calculate variable profit-sharing margins; instead they charge mark-ups identical to those in Murabahah. An exception is BMT Latanza which charges the mark-up on a declining balance, but a higher administrative fee; the effective charge is approx. 35% p.a.

Three of the four BMT offer Qard Al-Hassan at no remuneration to new microentrepreneurs; repayment is expected but not enforced. Loan sizes are small, mostly between Rp 100,000 or even 50,000 and 1m. BMT At-Taqwa also offers a variant, Qard, where repayment is enforced and loan sizes are somewhat larger, Rp 0.5-2.0m.

Three of the BMT charge no penalties in case of late payments; BMT Latanza negotiates penalties with the customer, arriving on average at an extra monthly charge of 2.5%.

The terms and conditions of financings in BMT At-Taqwa, the largest of the four sample BMT, are presented below. The portfolio includes two unremunerated financing products for start-up microentrepreneurs: Qard, accounting for 10% of the portfolio where repayment is enforced and collateral seized if necessary; and Qard al Hassan, accounting for 5% of the portfolio, which is repayable but no action is taken in case of defaulting. There are compulsory savings of 5% in Murabahah, which have to be deposited up-front, and in Qard, where they are deposited at the time disbursement (yet not interpreted as “deducted”).

Table 12: Financing terms and conditions of BMT At-Taqwa

	<i>Loan products</i>			
	<i>1: Murabaha</i>	<i>2: Mudarabahh</i>	<i>3: Qard Al-Hassan</i>	<i>4: Qard</i>
Portfolio	70%	15%	5%	10%
Number of borrowers	80%	4%	6%	10%
Minimum loan size in Rp million	1	5	0.1	0.5
Maximum loan size in Rp million	25	25	1	2
Profit-sharing margins:				
Nominal (flat)	18-24%	18-24	0	0
Fees if any	1.5%	1.5	0	0
Effective p.a. (approx.)	38-50%	38-50%	0%	0%
Profit-sharing vs. interest rates	A fair system			
Admin. fee for late payment	0	0	0	0
Minimum loan period in months	3	12	3	3
Maximum loan period in months	36	24	12	12
Instalment schedule	M	M	M	M
Collateral/guarantee requirements	Yes	Yes	No	No
Loan size tied to savings?	10%	No	5-10%	5-10%

Table 13: Non-performing loans and return on year-end assets in four BMT, 2003 (in %)

<i>BMT</i>	<i>NPL</i>	<i>ROA (yr-end)</i>
At-Taqwa	1.9	2.7
Ibaadurrahman	10	1.45
Latanza	1.4	1.7
Wira Mandiri	30	0.16

BMT At-Taqwa is the biggest and apparently best-performing BMT of the four sample cases, with a year-end ROA of 2.7% and a ROE (on paid-in capital) of 49%. Its balance sheet, income statement and performance ratios are given below. BMT Ibaadurrahman, with a ROA of 1.45, reports a good performance since it moved to its new location near the local market; within one year, its total assets more than doubled from Rp 150m to 341m. The performance of BMT Latanza is satisfactory, but seems to be contingent upon donations and government soft loans.

One poorly performing BMT was purposely included in the sample, namely BMT Wira Mandiri, which reports a break-even ROA of 0.16% for 2003, but is technically bankrupt. The manager reports massive delays and defaulting, which he attributes to a lack of knowledge and experience of management; high management turnover; weak controls by inexperienced supervisors; weak compliance with sharia; a lack of observance of prudential norms; and a conflict of interests in lending resulting in so-called buddy loans. Eg, the portfolio includes an investment of Rp 40.4m in a dental clinic and a return of Rs 1.36m or 3.4% during 2003, which is below the inflation rate. The NPL ratio is estimated at 30%. Rp 30m have to be written off. Provisioning is inadequate: Rp 4.15 in the balance sheet and Rp 1.5m in the income statement of 2003. The profit of Rp 1.26m in the balance sheet is thus grossly misleading. With a capital of Rp 26.8m and a volume of bad debts to be written off of Rp 30m the BMT is technically bankrupt.

Table 14: Balance sheet, income statement and performance ratios of BMT At-Taqwa, 31 December 2003 (Amounts in Rp million)

Balance sheet	2003
<i>Cash at hand</i> Kas	2.9
<i>Bank deposits</i> Giro, tabungan, deposito pada bank	406.7
<i>Gross loans/facilities outstanding</i> Pembiayaan yang diberikan kotor	1,819.4
<i>./. Loan loss reserve</i>	(80.0)
<i>./. Penyisihan Penghapusan, PYD</i> = <i>Net loans/facilities outstanding</i> = Pembiayaan yg diberikan bersih	1,739.4
<i>Net fixed assets</i> Harta tetap setelah dikurangi	49.4
<i>Other net assets</i> Aktiva lain-lain Bersih	12.8
Total assets Jumlah aktiva	2,211.2
<i>Savings and deposits of clients</i> Simpanan	1,957.9
<i>Donations from social institutions</i> <i>Baitul Maal</i>	1.4
<i>Borrowings (from shareholders)</i> Pinjaman	64.2
<i>Other liabilities</i> Kewajiban lain-lain	1.5
Total liabilities Jumlah kewajiban	2,025.0
<i>Paid-up capital</i> Modal dasar	120.0
<i>Social funds for employees</i> Cadangan	7.5
<i>Retained earnings</i> Laba tahun lalu	0.0
<i>Profit of current year</i> Laba tahun berjalan	58.7
Total equity Jumlah ekuitas	186.2
Total liabilities and equity Jumlah pasiva	2,211.2

Income statement	2003
Income (Pendapatan)	
Income from financial operations <i>Pendapatan marjin, bagi hasil, provisi, komisi</i>	509.4
+ Other operational income + <i>Jumlah pendapatan operasional lainnya</i>	40.1
Total income	549.5
Total pendapatan	
Expenditure (Biaya-biaya)	
<i>./. Interest or profit-sharing expenses</i>	199.0
<i>./. Beban marjin dan bagi hasil</i>	

./. Other operational expenses	262.8
./. Jumlah beban operasional lainnya	
Personnel expenses: amount	196.6
<i>Beban personalia:</i>	
Personnel expenses in %	74.8%
<i>Beban personalia di %</i>	
Loan loss provision (included above)	29.0
<i>Penyusutan dan penyisihan (di dalam)</i>	
Total expenditure	490.8
<i>Total biaya</i>	
Net profit (loss)	58.7
<i>Laba bersih (rugi)</i>	

Performance	2003
Loan recovery	
NPL, NPF in %	1.9
Loans written off in million Rp	0
Loan Loss Ratio in %	0
Profitability	
Return on year-end assets in %	2.7
Return on year-end earning assets in%	3.2
Return on paid-in equity in %	48.9
Ratios	
Equity/liabilities in %	5.9%
Deposits/liabilities in %	96.7
LDR Loan-to-deposit, FDR Financing-to-deposit ratio in %	92.9
CAR Capital adequacy in %	6.9
Efficiency	
Number of active borrowers/loan officer	100
BOPO Operational costs-to-revenue	89.3
Value of loans outstanding/loan officer in Rp million	363.8