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The Microbanking Division of Bank Rakyat Indonesia: A Flagship of Rural Microfinance in Asia[1]

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Abstract

The case of BRI is evidence that, in a deregulated policy environment, the microfinance section of a government-owned bank can (a) be transformed into a highly profitable, self-reliant financial intermediary; and (b) turn into a major microfinance provider, offering carefully crafted microsavings and microcredit products to low-income people at market rates of interest. Making good use of government seed money and the technical assistance portion of a World Bank loan during an initial phase, it has now fully substituted savings deposits for external loans as its source of funds. With a saver outreach to 30 million accounts and a borrower outreach to 3.1 million accounts (Dec. 2003) through a network of 4,185 outlets, BRI covers its costs from the interest rate margin and finances its expansion from its profits; arrears (1 day) stood at 2.2%, the long-term loss ratio (since 1984) at 1.62%, and return on assets at 5.7%. With non-targeted loans ranging from $35 up to $5800, the BRI Microbanking Division has a portfolio of $1.7 billion in loans outstanding and $3.5 billion in savings balances: evidence of a strong demand for deposit services (Dec. 2003). Excess liquidity amounted to $1.85bn. Several lessons can be drawn from BRI's experience:

Within a six-year period, 1984-89, the BRI unit system became a model case in Asia of the transformation of an ailing government-owned development bank into a viable and self-sufficient financial intermediary with ever-increasing financial resources and numbers of customers, competing successfully with a wide array of other local financial institutions. Further strength was added to BRI's microfinance operations during the Asian financial crisis: when the Indonesian banking system collapsed, BRI's Microbanking Division remained profitable (and probably saved the bank with its loss-making corporate lending), while attracting 1.3 million new savers during the three-month peak period of the crisis. Due to the success of its Microbanking Division, there is no doubt in BRI, which went public around to the turn of 2003/04, what the answer should be to the question, *Agricultural Development Banks: Close Them or Reform Them?*

Yet the immense success of the BRI units in terms of profitability and savings mobilization has generated a new challenge: How to re-invest their profits, on average substantially above $100m annually since the mid-1990s, in the unit system; and how to recycle the excess liquidity, consistently between $1bn and almost $2bn annually over the past ten years, in the village economies instead of siphoning it off into other areas of operation. In the long run, both better services ("taking the bank to the people") and deeper outreach should pay off for the BRI units. Given their high profitability, there are few, if any, economic constraints to financial innovations geared to financial deepening and poverty outreach.

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1. Rural microfinance in Indonesia: a highly differentiated sector

Rural financial infrastructure: Indonesia has one of the most differentiated rural financial sectors of any developing country, comprising 53,500 banking and semiformal financial units, 800,000 channeling groups and millions of rotating savings and credit associations (*arisan*) of indigenous origin. After the establishment of the first rural bank in 1895, a three-tiered system of rural finance developed rapidly, comprising national, district and village institutions. At the top is a century-old agricultural bank, now known as Bank Rakyat Indonesia (BRI). At the community level were originally two types of village banks, specialized in banking-in-kind and banking-in-money. In 1910, there were 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). There is a considerable coincidence between today's policy concerns in rural finance 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. (Holloh 1998, 2001; Seibel 1989; Steinwand 2001)

The sector now comprises some 6,300 formal and 47,200 semiformal microfinance outlets, serving about 47 million deposit accounts and 32 million loan accounts (Table 1).[2] Among them, the BRI Units (formerly *unit desa*) account for 80% of microsavings balances and 54% of microloans outstanding. Outside the formal and semiformal institutional sector are some 800,000 channeling groups of the poor and the ubiquitous *arisan*, a grassroots institution of most of the poor as well as the non-poor. Despite the extraordinarily high level of institutional differentiation, some 50% of rural households are reported to remain without access to formal and semiformal finance.

Table 1: Number and outreach of formal and semiformal MFIs (BRI and BKD Dec. 2003, others approx. 2000)

	Outlets	Deposit accounts		Deposit volume		Loan accounts		Loans outstanding		
		In '000	%	Rp bn	%	In '000	%	Rp bn	%	Av. loan Rp
Banks										
BRI Units	4,049	29,859	64	27,420	80	3,100	10	14,183	54	4,575,000
Rural banks (BPR)	2,213	4,698	10	5,066	15	1,745	5	5,628	21	3,225,000
Financial cooperatives*	40,527	11,043	24	1,659	5	11,093	34	4,787	18	431,500
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**

* Comprising 35,218 Unit Simpan Pinjam, 1,123 KSP, 1,071 Credit Unions, 2,938 BMT and 177 Swamitra.
** Errors in percentage totals due to rounding.

[2] 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).

Policy framework: Following the oil price increases of 1973 and 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% in 1973/74 to 5.7% in 1985/86: an important prerequisite for financial market liberalization. In rural finance, the policy environment evolved rapidly during the 1980s and 1990s. This was highlighted by:

- full interest rate deregulation and elimination of credit ceilings in 1983 (preceded by the oil crisis of 1982), which gave birth to the market-oriented reform of the BRI unit system.
- institutional liberalization and the passing of a rural banking law 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.
- the phasing out of 32 out of 36 subsidized credit programs in 1990.
- a new banking law in 1992, recognizing two types of banks: commercial banks and rural banks.
- 1997-2002: financial sector crisis management geared to prudential regulation and effective supervision.

This was paralleled by GDP growth rates averaging 7% p.a. during 1979-96 and a reduction of poor from 60% in 1970 to 11.5% (= 22.5m people) in 1996 (World Bank 1999). 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 (ie, *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. Since 2000, there have been clear signs of recovery. 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 microfinance law in September 2001.

2. The failure of subsidized targeted credit in a repressive policy environment…

Until 1983, interest rates in Indonesia were regulated, the financial sector was dominated by state banks, and the establishment of new banks and branches was restricted. The century-old Bank Rakyat Indonesia (BRI) was the main provider of agricultural credit. Most prominent among a multitude of priority programs was BIMAS, an agricultural diversification program with a microcredit component. BIMAS loans were channelled at heavily subsidised rates through BRI, which had greatly expanded its sub-branch network to the level of 3,300 village units (*unit desa*)[3] to handle the BIMAS loans. However, in the absence of incentives for small farmers to repay and for a BRI staff of 14,300 to enforce credit discipline, repayment rates lingered around 40-50%, resulting in heavy losses. To the borrowers, the benefits of subsidized credit were drastically reduced: by a shift of transaction costs from lender to borrower, under-the-table charges, onerous procedures, frequent delays beyond the agricultural input time and restrictions of loan purposes to production-oriented agricultural targets. When oil prices dropped and GDP fell, the government decided it could no longer afford massive support for such a poorly performing microcredit program. *Close it or reform it,* was the directive given by a number of financial sector policy makers.

[3] The village units are actually established at subdistrict (*kecamatan*) level; *rural units* would be more accurate.

3. … and the transformation of BRI units into viable rural microfinance institutions in a deregulated policy environment

After the interest rate deregulation in June 1983, the new management of BRI decided to commercialise the units (*unit desa*) into self-sustaining profit centres. With technical assistance from the Harvard Institute for International Development supported by USAID, the bank estimated microsavings and microcredit transaction costs, and carefully crafted two commercial products. One was a rural savings scheme with a lottery component, SIMPEDES (*simpanan pedesaan*, *rural savings*), which proved to be immensely attractive and at the same time served as an instrument of resource mobilization at village level.[4] The other product was a non-targeted credit scheme, KUPEDES (*kredit umum pedesaan, general rural credit*) open to all and for any purpose. Its features included simple procedures, short maturities, regular monthly instalments mainly from non-agricultural income, flexible collateral requirements (none for very small loans), incentives for timely repayment, repeat loans contingent upon successful repayment of previous loans, and market rates of interest amounting to 2% flat per month (equal to an effective rate of 44% p.a., minus 11% for timely repayment = 33% p.a.)[5] to cover all costs and risks. For loans of Rp 25m to 50m, the current flat rate is 1.6% p.m., minus a rebate of 25% for timely repayment.

In 1998, in response to the financial crisis, BRI was reorganized into three divisions: a Corporate Banking Division for loans above Rp 3 billion ($300,000 at the Oct. 1988 exchange rate), a Retail Banking Division with 323 branches which offer savings deposit services, provide loans on commercial terms from Rp 25 million to Rp 3 billion ($2,500-$300,000) and handle the remaining subsidized targeted credit programs; and a Microbanking Division, with 4,185 outlets (2,566 village units, 1,220 peri-urban units, and 379 village posts) for smaller loans. At the time of writing (16 March 2004), the loans from the units according to BRI regulation may range from Rp 25,000 (US$ 2.90) to Rp 50m (US$ 5,800); but BRI reports that in the field actual minimal loan sizes are more like Rp 300,000 (US$ 35). According to the same regulation, loans up to Rp 5m (US$ 580) may be collateral-free; but most unit managers do ask for collateral, which may comprise land or mobile collateral such as bicycles or TVs.

In 2/1984, at the start of the new scheme, all of BRI's village units were turned into profit centres with substantial profit-sharing incentives for staff, paralleled by penalties for arrears exceeding 5%; eg, unit managers lose their credit authority. Programs carried out on behalf of the government and of donors were kept from the village units and confined to the branch level.

As of Dec. 2003, at the time of its 20th anniversary, the Microbanking Division served 3.1m loan accounts, with loans outstanding amounting to US$1.68bn; or $542 per loan account); the number of savings accounts had grown to 29.9m, amounting to $3.53bn; or $118 per account (Table 2). In recent years, the profits of the Microbanking Division have been substantially above US$ 100,000 (eg, $186m in 2002). Since 1989, savings mobilized have exceeded loans outstanding, with excess liquidity increasing from US$ 1.12bn in 1993 to US$ 1.85 in 2003.

[4] Of the gross interest rate of 13%, savers received 11.5%, while 1.5% were put into a lottery fund.
[5] This resulted in an on-time repayment rate of 95% in 1984 and 98% in 2003 (see Table 2).

Table 2: Savings and loans outstanding in BRI village units, Dec. 1984 – Dec. 2003

Year	*Savings deposits*		*Loans outstanding*							
	No. of ac-counts	*Amount in mn US$ o.*	*No. of ac-counts*	*Amount in mn US$.*	*Savings to loan ratio*	*Excess liquidity mn US$ o*	*12-month loss ratio*	*Arrears ratio**	*Return on assets*	*US$ ex-change rate***
1984	2,655	39.3	640,746	103.4	38%	-64.2	1,0%	5.4%	n.a.	1,074
1985	36,563	75.5	1,034,532	203.6	37%	-128.1	1,8%	2.1%	n.a.	1,125
1986	418,945	107.1	1,231,723	203.7	53%	-96.6	2,7%	4.5%	n.a.	1,641
1987	4,183,983	174.2	1,314,780	260.4	67%	-86.1	3,0%	5.8%	n.a.	1,650
1988	4,998,038	284.8	1,386,035	313.3	91%	-28.5	4,6%	7.4%	n.a.	1,731
1989	6,261,988	484.6	1,643,980	427.7	113%	56.9	2,3%	5.4%	n.a.	1,979
1990	7,262,509	891.5	1,893,138	726.9	123%	164.7	2,0%	4.1%	3.0%	1,901
1991	8,587,872	1,275.4	1,837,549	730.8	174%	544.6	4,9%	8.6%	2.7%	1,992
1992	9,953,294	1,648.4	1,831,732	799.5	206%	849.0	3,4%	9.1%	2.6%	2,062
1993	11,431,078	2,049.9	1,895,965	927.7	221%	1,122.2	2,2%	6.5%	3.3%	2,110
1994	13,066,854	2,381.4	2,053,919	1,118.8	213%	1,262.5	0,7%	4.5%	5.1%	2,197
1995	14,482,763	2,633.8	2,263,767	1,397.2	188%	1,236.6	1,1%	3.5%	6.5%	2,284
1996	16,147,260	3,002.4	2,488,135	1,725.7	174%	1,276.7	1,6%	3.7%	5.7%	2,362
1997	18,143,316	1,622.0	2,615,679	860.0	189%	761.9	2,2%	4.7%	4.7%	5,448
1998	21,698,594	2,043.5	2,457,652	594.5	344%	1,449.1	1,9%	5.7%	4.9%	7,901
1999	24,235,889	2,420.1	2,473,923	844.9	286%	1,575.2	1.7%	3.1%	6.1%	7,050
2000	25,823,228	1,986.0	2,715,609	813.2	244%	1,172.7	1.1%	2.5%	5.7%	9,625
2001	27,045,184	2,105.2	2,790,192	945.2	223%	1,160.0	0.5%	2.2%	5.8%	10,446
2002	28,262,073	2,627.3	3,056,103	1,343.9	195%	1,283.4	1.7%	1.6%	6.4%	8,937
2003	29,869,197	3,527.3	3,100,358	1,678.2	210%	1,849.1	1.9%	2.5%	5.7%	8,451

Source of original data: BRI, Laporan Statistik BRI Unit, January 2004

* Total payments overdue one day or more in % of total loans outstanding, excluding loans written off.

** End-of-year rates. Sources: 1984 – 1992: Bank Indonesia, Badan Pusat Statistik Indonesia; 1993 – 2003: http://www.oanda.com/convert/classic.

4. Savings as a source of funds: Making BRI self-reliant – and donor funding superfluous

With this model, BRI became what is probably the most successful microfinance bank with a rural mandate in the developing world. Three major sources of funds have been involved :

(i) an injection of Rp 210 billion ($20m) of seed capital in 1984 by the government as start-up liquidity for loans and initial administrative costs, which were fully used by 1986, when the units were turning a profit;
(ii) a World Bank loan of $102 million, $5 million of which was provided in 1987 for technical assistance and $97 million in 1989 for onlending (Table 3) - at a time when it was no longer needed because the unit system had broken even with its internally mobilized resources;
(iii) savings deposits, vigorously mobilized at village level and remunerated at positive real terms.

Table 3: Sources of funds of the BRI village units, 1984-1989, 12/1996 and 6/2003

Source of funds	Year	Amount in million $
Government initial capital injection	1984	20
World Bank loan:		
Technical assistance	1987	5
Liquidity fund for onlending	1989	97
Deposits:	1989	534
	1996	2,976
	6/2003	2,990
Loans outstanding:	1989	471
	1996	1,710
	6/2003	1,600

* Including current accounts, passbook savings and time deposit accounts.

SIMPEDES, voluntary savings withdrawable at any time, with a lottery component, proved to be BRI's most attractive savings product, outperforming time deposits by a wide margin. By December 1989, BRI had broken even: fully mobilizing its loanable funds through village-level savings and generating excess resources thereafter (Table 3). Disbursement of the World Bank loan in 1989 came thus at a time when BRI had outgrown the actual need for it; and the funds were used at (mostly unprofitable or even loss-making) corporate and branch levels. Ever since, BRI's *unit desa* network has been completely self-reliant (mobilizing its own resources) and viable (covering its costs and making a profit). As a result of a continual increase in the number of savings accounts, particularly during the financial crisis of 1997/98, the BRI units, as of June 2003, served close to 30 million savings accounts in probably about 50% of households in Indonesia, at a borrower-to-saver ratio of roughly 1:10. Savings balances on that date amounted to $2.99bn, averaging $102 per account. BRI's self-reliance in terms of fund mobilization and profitability has created the material base for its autonomy and freedom from political interference which has so severely afflicted the rest of the banking system.

5. Outreach, transaction costs and profitability

The BRI units reached their break-even point eighteen months after the inception of their reform, generating a profit of Rp 9.8bn ($8.7m) in 1985. For the period 2/1984-12/2003, the long-term loss ratio (total overdue one day or more, including amounts written off, divided by total which has fallen due during that period) was 1.9%. Total payments in arrears one day or more as a percentage of total loans outstanding, excluding write-offs, were 2.2% in Dec. 2001, 1.6% in 2002 and 2.2% in 2003. Since 1994, return on assets (ROA) has been consistently around 5%-6%. ROA was 6.4% in 2002 and 5.7% in 2003. (Table 2) Consolidated profits at unit level amounted to $177m in 1996, $94m in 1998, $167m in 1999, $119m in 2000, $129m in 2001 and $186m in 2002. Since 1987, Yaron's subsidy dependency index (SDI) has been negative (Charitonenko, Patten and Yaron 1998). After 20 years, there is still no sign of the often-quoted iron law in microfinance of an increase in defaults and a fall in profits over time.

BRI has demonstrated that in a deregulated policy environment, a public bank is capable of serving vast numbers of microsavers and microborrowers at competitive interest rates: mobilizing its resources internally, covering its costs, and financing its expansion from its profits. BRI has proven that institutional viability, sustainability and outreach to low-income people are compatible.

Today the BRI units are the biggest provider of rural financial services within Indonesia's highly differentiated rural financial infrastructure (Table 1; data pertain to around 2000, data on BRI and BKD to 2003). Among the 54,000 outlets listed, 7% are BRI units, 4% formal sector rural banks (BPR), 3% are semiformal rural banks (LDKP), and 10% are non-formal village banks (BKD) which report to Bank Indonesia but are not regulated; the remaining 76% are cooperatives. The BRI units account for 62% of all savings deposit accounts, 74% of deposits, 8% of all loan accounts and 39% of loans outstanding.

The superior performance of the BRI units in terms of outreach and financial deepening is due to various factors. One is the attractive design of their savings and credit products; another one the lowering of transaction costs through economies of scale. BRI includes among its customers both poor and non-poor borrowers and cross-subsidizes small loans with the profits from larger loans, which have substantially lower transaction costs. On principle, the poorest have access to the units; however, in remote areas, they are more likely to be serviced by special programs of limited outreach such as P4K, handled at branch level. Reaching out to poorer segments of the rural population and contributing to their overall uplifting remain one of the big challenges to the units.

Transaction costs of two BRI *unit desa* were studied by Feekes (1993) on behalf of Bank Indonesia in 9/1991-1/1992 and compared with four commercial bank branches , five formal rural banks and three semiformal rural banks (BKK), all in Central Java. It was found that transaction costs vary, as expected, by credit size. In the case of BRI units, they amounted to 26% of loans below $250, 10% of loans between $250 and $2,500, and 3% of loans between $2,500 and $12,500, which at that time were the units' main source of profitability, cross-subsidizing the micro-loans. Smaller institutions were found to be relatively more efficient in the delivery of very small loans, with estimated break-even points of $105 among the BKK sample units, $225 among rural banks, somewhat above $250 among BRI units, and above $12,500 among commercial banks. Three major conclusions follow:

(i) For an institution like BRI to maximize its outreach and yet remain profitable, it has to include among its customers both the poor and the non-poor and cater for their respective demands for smaller and larger loan sizes, whereby the latter cross-subsidize the former. Excluding the non-poor from its clientele would substantially reduce its outreach to the poor.[6]
(ii) Only small local financial institutions, such as cooperatives and other village-based institutions, can handle very small loans cost-effectively.
(iii) In order to reach all segments of the rural population with financial services, it takes a differentiated rural financial infrastructure in which various types and sizes of financial institutions compete with each other.

6. BRI units since the Asian financial crisis: stronger than before

The impact of the crisis on MFIs has not been uniform, bringing out both the strengths and the weaknesses of different subsectors. However, one basic observation applies to the sector as a whole: while the commercial banking sector virtually collapsed, microfinance weathered the crisis well. This testifies on the one hand to the strength of the legal and institutional foundations of the microfinance sector, its self-reliance, and the public's trust in MFIs; and on the other hand to the absence of the two fundamental problems of the commercial banks: political interference in lending decisions; and excessive foreign exchange risk exposure of the banks and their clients. In contrast, MFIs have mobilized their own resources domestically; and most of them have applied sound lending practices.

On a more detailed level, the impact of the crisis has been stunningly positive on the BRI units. During the crisis year 9/1997-8/1998 total savings deposits in BRI almost doubled: in the BRI units from Rp 7.98 trillion in 8/1997 to Rp 15.13 trillion in 8/1998 (+89.6%); and in all of BRI from Rp 17.86 trillion to Rp 35.17 trillion (+96.9%): an increase well above the inflation rate of 56% during 9/1997-8/1998. During the three-month period June-August 1998, after Indonesia had

[6] Staff incentives are based on unit profits, but take into account the market potential of the area of operation.

been hit by both a drought and an economic crisis, 1.29 million new savings deposit accounts were opened in BRI units (bringing the total up to 20.93 million); and an additional Rp 2.84 trillion ($284 million at the Oct. 6, 1998, exchange rate) were deposited. There was only a slight nominal increase in the credit portfolio, which stood at Rp 4.61 trillion in 8/98 (up only 4.5% from Rp 4.41 trillion in 8/97), amounting to a substantial decrease in real terms.

Table 4: Savings, loans and excess liquidity in BRI units during the crisis year, 8/1997-8/1998

Time	*Savings deposits in Rp.*	*Loans outstanding in Rp.*	*Excess liquidity in Rp.*
8/1997	7.98 trillion	4.41 trillion	3.57 trillion
8/1998	15.13 trillion	4.61 trillion	10.52 trillion
Increase in %	+89.6%	+4.5%	+194,67%

Because of uncertainty over future developments, people reportedly were cautious to take up new loans. Accordingly, the number of BRI KUPEDES borrowers which had steadily increased from 640,746 in Dec. 1984 to 2,615,696 in Dec. 1997, stagnated. During 1998 it actually declined every single month: from a peak of 2,628,559 in January to 2,508,049 in August: a decrease of -4.6% for that eight-month period; and a decrease of –1.4% since August 1997. The amount of loans outstanding continued to increase slowly in nominal terms from Rp. 4.41 trillion in August 1997 to Rp 4.69 in Dec. 1997. After a nominal peak of Rp 4.75 trillion in January 1998, it declined to Rp 4.55 trillion in May and reached Rp 4.61 trillion in August 1998. The amount of loans outstanding thus decreased by 3.0% during the first eight months of 1998; since August 1997, it increased by 4.5%.

The crisis had no negative effect on repayment, testifying to the resilience of both the BRI village units and their farmer and microenterprise customers. The 12-month loss ratio (2.16%) during the crisis period (9/1997-8/1998) is virtually identical with the long-term loss ratio since 1984 (2.17%). Until December 1998, it further improved to 1,94%. In 8/1998, right after the peak of the crisis, BRI even experienced an unprecedented negative one-month loss-ratio
(-0.21%): more than what was due was repaid.

7. The new challenges of microfinance profits and savings: cross-subsidization in reverse

BRI is generally renowned as the bank which revolutionized rural microfinance, correctly so. The microbanking division is indeed highly profitable, and its outreach is vast; but it is only one of three divisions, accounting for 34% of total assets, 31% of loans outstanding and 41% of deposits in 2001 (Table 5). However, the bank as a whole is loss-making, and, without its Microbanking Division, might have been closed down after the financial crisis of 1997-98. The units have cross-subsidized the bank in two ways:

- Through the continual transfer of profits from the units to the consolidated bank; and
- through the transfer of savings mobilized at village level to the branches.

Table 5: BRI consolidated and BRI units, selected balance sheet data 2001 (in US$ million)

	BRI consolidated	BRI units
Total assets	7,326	2,511
Government recapitalization bonds	2,616	-
Placements with BRI branch system	-	1,361
Net loans outstanding	2,843	885
Liabilities	6,861	2,307
Savings and time deposits	5,125	2,115
Total equity	465	210
Paid-up capital	166	98
Retained earnings/Profit current year	-2,508	112
Additional paid-in capital	2,807	-

Source: Hiemann 2003:82-83

Transferring profits: Accumulated losses amounted to US$ –4.0bn in 1999, US$ –2.8bn in 2000, –2.5bn in 2001 and US$ –2.8bn in 2002, respectively (Table 6)[7], despite the continual transfer of profits from the units since 1986. Without its microfinance division, it would probably have been among the banks closed down after the Asian financial crisis, when huge amounts of corporate loans turned bad. With total equity at US$ -3.65bn, the bank was technically bankrupt in 1999. In 2000, a new management took over, and the government injected some US$ 3bn. The corporate market was all but abandoned, and the bank focused fully on the micro, retail and SME markets. This resulted in a turn-around of the bank, which was internationally rated as *BBB* in 2001 (a better risk than the country at *C*). This new policy has been so successful that around the turn of 2003/04, the bank is now being partially privatised and traded on the stock market.

Table 6: Paid-up capital, capital injections, and earnings of BRI consolidated and BRI Units, 1999-2002 (in US$ million)

	BRI consolidated*			BRI units**		
Year	Paid-up capital	Capital injections and other	Retained earnings	Capital and reserves	Net profit	Retained earnings
1999	244	83	–3,996.8	92	167	Transferred annually to BRI branches
2000	180	3,055	–2,802.3	85	119	
2001	166	2,807	–2,497.1	98	129	
2002	193	3,252	–2,808.8	262	1864	

Hiemann 2003: 82, 89; Laporan Statistik BRI Unit, June 2003 and Jan. 2004

Siphoning off savings: While the credit bias in development finance from the 1960s onwards has never given way to a savings bias, despite a widespread demand for savings services among the poor, savings are no longer "the forgotten half of rural finance" (*R. Vogel*). In a good number of institutions without a bias either way, ratios of borrowers to savers are between 1:4 and 1:10. To those familiar with the early history of microfinance in Europe during the 18th and 19th century, this comes as no surprise (Seibel 2003). However, not all donors have learned that lesson: that the poor need both savings and credit services; but more of the poor need savings deposit facilities than credit. The BRI units, with 30m savings accounts (including various types of savings and fixed deposits) and a balance of $3.53bn as of 12/2003, have responded to that demand.

Yet, the units' success in savings mobilization has created a new problem: recycling the savings within the village economy vs. siphoning them off. Since 1989, the units have produced excess liquidity, for the past ten years consistently above US$ 1bn per year. These levels

[7] Annual losses in BRI consolidated have a slightly declining trend; the wide variations in US$ terms are mainly due to changes in the exchange rate (see Table 2, last column). In (nominal) billion Rupiah, retained earnings for the four years were –28,177.5; –26,972.3; –26,084.7; and –25,102.3.

have been highest during the crisis years 1998 and 1999, with $1.43bn and $1.56bn, respectively – at a time when donors rushed to Indonesia to provide fresh credit lines, thereby further raising the country's mountain of external debts. The units are required to place their excess liquidity with the BRI branch system; net placements amounted to $1,60bn in 1999, $1.24bn in 2000, $1.23bn in 2001 and $1.645 in 2002.

Despite the outreach of the various types of rural MFIs in Indonesia, numerous studies (eg, ADB 2003; Holloh 2001; Seibel 2003b) have shown that there still is a vast unsatisfied demand for credit: in villages at a distance from the sub-district center, where the BRI units are located, and in remote and marginal areas, particularly on the outer islands, where large tracts of lands are totally unserved. Here is not the place to propose new strategies and products to BRI. But there are two questions deserving an answer: (a) Should the unit system extend its single credit product strategy (*KUPEDES*) and develop additional credit products, with village-level and perhaps even doorstep services, at least in the more profitable units? (b)Should the unit system invest part of its profits in remoter areas by establishing agencies of a smaller size than the usual staff of four, perhaps at the same time reducing transaction costs through linkages with self-help groups in cooperation with Bank Indonesia's revamped linkage banking program? (Seibel 2003c; Steinwand 1997)

8. Summary

The case of BRI is evidence that, in a deregulated policy environment, the microfinance section of a government-owned bank (a) can be transformed into a highly profitable, self-reliant financial intermediary; and (b) can turn into a major microfinance provider, offering carefully crafted microsavings and microcredit products to low-income people at market rates of interest. Making good use of government seed money and the technical assistance portion of a World Bank loan during an initial phase, it has now fully substituted savings deposits for external loans as its source of funds. With a saver outreach to 30 million accounts and a borrower outreach to 3.1 million accounts (Dec. 2003) through a network of 4,185 outlets (3,786 units operating as profit centers and 379 village posts), BRI covers its costs from the interest rate margin and finances its expansion from its profits; arrears (=1 day) stood at 2.2%, the long-term loss ratio (since 1984) at 1.62%, and Return on Assets at 5.7%. With non-targeted loans from $3 in theory and $35 in practice up to $5800 at rural market rates of interest and unrestricted deposit services, the BRI Microbanking Division has weathered the Asian financial crisis well, in stark contrast to the overall government banking sector including BRI consoldiated, a loss-making bank. As of Dec. 2003, its portfolio comprised $1.7 billion in loans outstanding and $3.5 billion in savings balances. Excess liquidity amounted to $1.85bn. Several lessons can be drawn from BRI's experience:

- Financial sector policies work and are conducive to financial innovations.
- With attractive savings and credit products, appropriate staff incentives, and an effective system of internal regulation and supervision, rural microfinance can be highly profitable.
- The poor and near-poor can save; and rural financial institutions can mobilize their savings cost-effectively.
- If financial services are offered without a credit bias, the demand for savings deposit services effectively exceeds the demand for credit by a wide margin.
- Incentives for timely repayment work.
- Outreach of a financial institution to vast numbers of low-income people is compatible with including viability, self-reliance and financial self-sufficiency.
- Average transaction costs can be lowered, and both the profitability of a financial institution and the volume of loanable funds can be increased, by catering for both the poor and the non-poor with their demands for widely differing deposit and loan sizes.

Within a six-year period, 1984-89, the BRI unit system became a model case in Asia of the transformation of an ailing government-owned development bank into a viable and self-sufficient financial intermediary with ever-increasing financial resources and numbers of customers, competing successfully with a wide array of other local financial institutions. Further strength was added to BRI's microfinance operations during the Asian financial crisis: when the Indonesian banking system collapsed, BRI's Microbanking Division remained profitable (and probably saved the bank with its loss-making corporate lending), while attracting 1.3 million new savers during the three-month peak period of the crisis. Due to the success of its Microbanking Division, there is no doubt in BRI, which went public around to the turn of 2003/04, what the answer should be to the question, *Agricultural Development Banks: Close Them or Reform Them?* (Seibel 2000)

Yet the immense success of the BRI units in terms of profitability and savings mobilization has generated a new challenge: How to re-invest their profits, on average substantially above $100m annually since the mid-1990s, in the unit system; and how to recycle the excess liquidity, consistently between $1bn and almost $2bn annually over the past ten years, in the village economies instead of siphoning it off into other areas of operation. In the long run, both better services ("taking the bank to the people") and deeper outreach should pay off for the BRI units. Given their high profitability, there are few, if any, economic constraints to financial innovations geared to financial deepening and poverty outreach.

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