Improving Access to Financial Services in Indonesia

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Executive Summary

Access to formal financial services is by now widely recognized as critically important to alleviating poverty around the world. An impressive literature has developed supporting the proposition that increased access to financial services has a significant impact on poverty. Financial inclusion is high on the policy agenda of several developing countries worldwide[1] where banking and financial systems are usually underdeveloped, and often cater only to large firms and/or high-income individuals. This skewed distribution of finance hinders the growth and development of smaller firms and poorer households. There is a growing recognition that increasing access to formal financial services has both private and social benefits. Extending the breadth of financial service availability fosters economic growth and can improve income distribution. Providing access to financial services means mainstreaming people in many dimensions, fostering economic inclusion, and providing financial institutions with new and expanding markets. Improving access requires actions on both the supply and demand side, by both the public and private sectors as well as changes in the institutional environment. Recent experiences in several countries show that with the right information on who lacks access and for what reasons, policies can be adjusted and products can be designed to scale up access, especially with new technology.

The Government of Indonesia has also placed high importance on this issue acknowledging the significance of access to financial services as a constraint to development, and the authorities are initiating policies aimed at increasing access. One of the key constraints to concrete policy action in improving access to financial services, in particular at the household level, is concrete data and analysis on what exactly the demand-side view of the constraints is i.e. what do consumers and the currently un-banked population think of financial services, what access do they have and what products and services do they need. Such information would provide a solid basis that can inform policy and product development by the market to achieve the desired outcomes. While a significant amount of data and analysis is available on the issue of *access to credit* by Small and Medium Enterprises (SMEs) [2], there is a dearth of such work in the area of *access to broader financial services*.

The objective of this report – whose key feature is a nationwide household survey of access to financial services - is to provide data, analysis, and recommendations that can assist the authorities as well as other stakeholders such as the financial services industry in getting an insight into access to financial services

1 See, for example, the work of Beck, Demirguc-Kunt and Martinez Peria (2004), (2005) and (2006). Banking the Poor (2009c), Access to Finance Study: Brazil (2004), India (2006c), Nepal (2007b), and Pakistan (2009b)

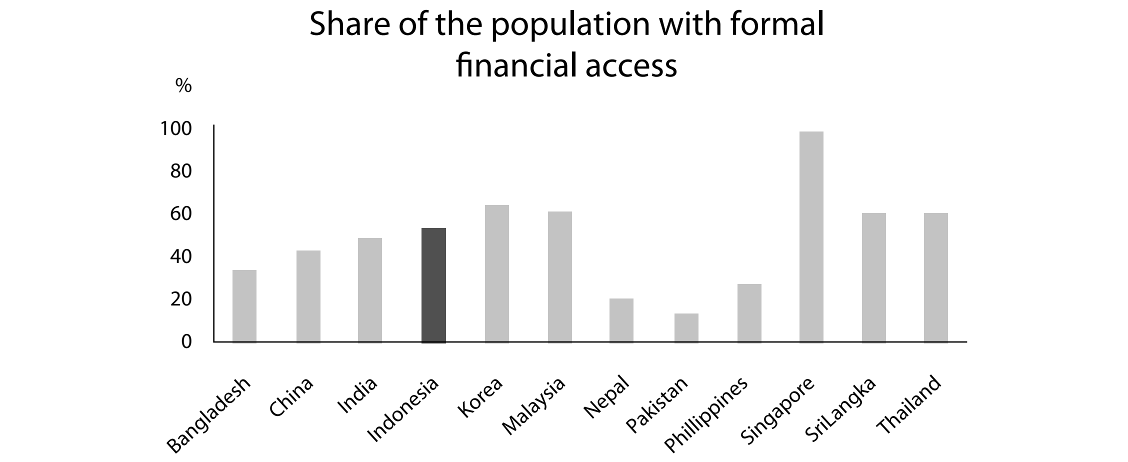
2 World Bank (2006e),"Making the New Indonesia Work for the Poor,"; World Bank (2006):"Revitalizing the Rural Economy: An assessment of the investment climate faced by non-farm enterprises at the District level" ; Significant work done by GTZ on rural banks: See http://www.profi.or.id/; FAO and IFAD on rural finance: http://www.ruralfinance.org/ and http://www1.deptan.go.id/kln/FAO%20in%20%20Indonesia.htm. ILO on migrant workers: See http://www.ilobkk-migration.org/, IFC/GTZ, and CGAP (2009d), ADB (2007): "Low Income Households' Access to Financial Services" (2007), which includes coverage of Indonesia.

in Indonesia. It begins with a review of the supply side of financial services from an access perspective, followed by an examination of the demand side of access to those services. It then looks at regulatory barriers that can help increase financial inclusion and certain other closely related topics that are of current policy interest, namely MSMEs, overseas migrant workers and mobile banking. The immediate purpose of the report is to inform policy-makers and the industry on who does (and does not) have access to financial services, including the constraining factors for broader access. The objective is to identify—as specifically as possible—measures that can lower barriers to access for poorer households, especially measures that work in cost-effective ways.

Survey Results on the Demand for Financial Services

Just about half of Indonesia's population has access to formal financial services. This is better than countries such as China, Pakistan, Bangladesh, and the Philippines. However, it is worse than countries such as Sri Lanka, Thailand, and Malaysia.

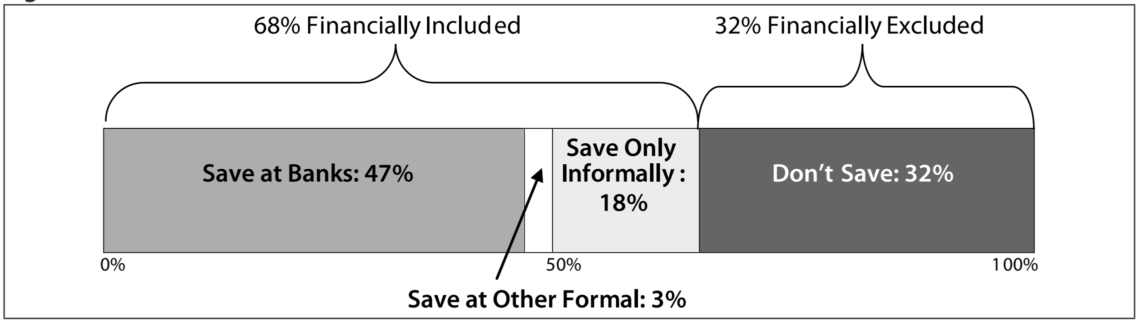
Figure 1: Share of the Population with formal financial access



Sources: World Bank 2008; Nenova, Niang, and Ahmad (2009); Indonesia Access to Finance Survey

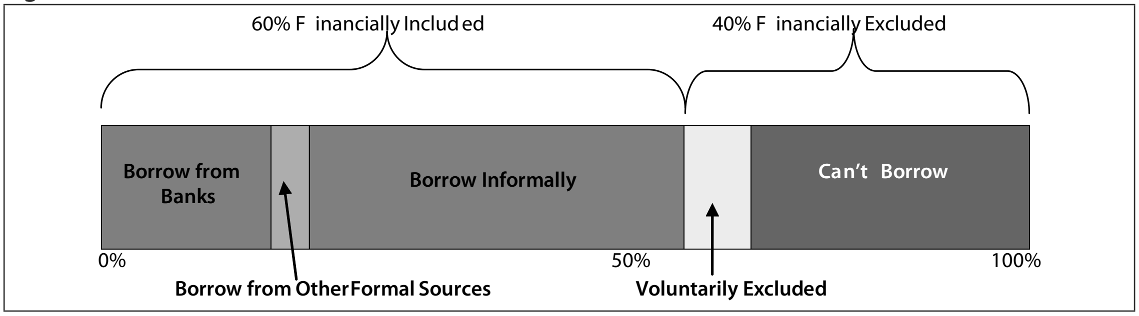
Commercial banks – that dominate the Indonesian financial sector - serve a relatively small proportion of Indonesian households. One-third of Indonesians don't save at all, and can be considered 'financially excluded' (see Figure 2 below). Similarly, less than half of Indonesians save at banks, and of those who do save at banks, two-thirds also save at some other type of service providers. Considering the overlap between banks and the informal sector, informal institutions actually service more savers than do banks.

Figure 2: Savers' Financial Inclusion



A mere 17% of Indonesians borrow from banks, and about 1/3rd more borrow from the informal sector. On this basis, roughly 40% of the population is 'financially excluded' from credit (see the Figure 3 below). The most important reason for exclusion appears to be inadequate documentation; evidence indicates that lack of collateral is a secondary reason.

Figure 3: Borrowers' Financial Inclusion



The single most important financial service that households would like to have is a bank account. The most important reason for having a bank account is 'security'; by far the most important reason for not having a bank account is 'lack of income' or not having a job. Bank credit is important for households too, but it is considerably further down the list of priorities. Credit is still concentrated in the informal sector; and sources of credit are widely diversified among service providers.

Taken together, the above findings underscore the importance of expanding both the liabilities and assets (that is, deposits and credits) sides of financial services institutions, while raising depositors' incomes by broader policies of economic development. They also underscore the challenge to Indonesia's formal financial system, especially the banks, of significantly expanding its client base, to reach a much larger portion of the population. The 'truly financially excluded', which is to say, those who have neither a savings account nor a loan are predominantly poor, poorly educated, live off-Java in rural areas, and do not own non-farm enterprises. Off Java residents are more than twice as likely to have neither a bank account nor a loan, than are on Java residents.

Physical access to formal financial services is not a generalized problem; for the vast majority (some 95%) of Indonesians accessibility to banks is rated as convenient (or very convenient). The exception is the rural, off-Java regions, especially if water transport is involved. Nonetheless, it's notable that average travel times to reach bank branches compare favorably to key public services like hospitals, schools and other health facilities.

One simple, low-cost solution for borrowers who want a lower interest rate on credit, is for them to open a bank account. Banks and MFIs both charge nominal interest rates of about 30% per annum, and both offer lower rates to borrowers who have a bank account. Nominal interest rates from other formal and informal sources of credit except for loans from employers, friends and neighbours tend to be higher. Therefore, enabling poor households to open a bank account would be a simple way to get them linked to the formal financial system and, among other benefits that it may offer, could help lower interest rates on their borrowings.

Consumers do respond to more attractive pricing of financial services including lower charges on savings accounts. However, demand looks somewhat price inelastic which implies that banks' need to carefully consider whether it is in their financial interest to reduce fees. This is consistent with identified bank policies that set deposit rates and administration fees in a way that discourages small savers. One policy option in this regard is to encourage banks to offer basic banking services or 'no frills' accounts (noting that some banks already do so and, under an agreement between several major banks and Bank Indonesia, ns are afoot to introduce more such accounts in 2010). Several countries in the world are implementing such schemes, although in different ways. Another option would be to encourage regulatory and technological advances (like mobile banking) that allow all service providers to reach more customers at lower cost, although international experience shows that while mobile banking has had a significant impact on payments services, it has had less impact on other financial services. Another innovation, especially given Indonesia's geography would be to focus on bank partnerships with non-bank correspondent outlets of all forms to spread services.

Some new products that would be of interest to consumers are contractual savings products for urban residents or mobile savings services for rural residents. As for extending the reach of formal bank services deeper into the lower strata of society, the most promising avenue looks like mobile banking – even if at first, it is likely that mobile banking is largely likely to be focussed on payments services. Even the poorest in remote villages have access to mobile phones these days, and the survey uncovers considerable interest in mobile banking among those with a mobile phone, but no bank account.

Key Aspects of the Current Supply of Financial Services

Although the number of banks has declined substantially since the 1997/98 crisis, banks have significantly expanded the reach of their financial services through greater branching and use of ATMs. Other formal sector providers such as cooperatives and the state owned pawnshop have also expanded physical outreach. Per capita income and population (or land mass) go a long way towards explaining the reach of Indonesia's commercial banking system, on a provincial basis. The only notable exceptions relative to the average are Jakarta (which is 'over-serviced') and East Kalimantan (which is large, resource rich, sparsely populated and 'under-serviced').

In considering banks, it is important to distinguish between the commercial banks and People's Credit Banks (BPRs), which are regional in nature and much smaller in size. Among the former, only a relatively small number currently make a large, direct contribution to the financing of poorer households. And even among these, their focus tends to be on better-off clients. However, the commercial banks do make important contributions in other ways, for instance, indirectly through the so-called 'linkage program' with BPRs. In addition, their numbers include one of the largest micro finance institutions in the world (BRI's Unit Desa system), and they are aggressive, opportunistic competitors who are quick to move into promising new markets. Such characteristics imply that the commercial banks are the institutions most likely to introduce new cost-cutting technologies and to put competitive pressure on other financial institutions. Still, they are only a part of the near-term answer to better access to financing because they do not currently reach deeply enough into the lower strata of Indonesian society.

By contrast, the BPRs and other small financial institutions offer much more promise in the near- to medium-term. Despite a great deal of diversity, they are often on the frontline of the delivery of financial services to MSMEs and poorer households, including in very remote parts of Indonesia. As detailed below, much can be done on the regulatory front to extend their reach into lower segments of Indonesian society.

Sharia banking (and more generally, sharia financing) – though currently holding a small market share - has been expanding rapidly for about a decade. These institutions are particularly important because they cater almost exclusively to the lower end of the market, including in rural regions. Also, Indonesia's first sharia bank (established in 1992) is a leading innovator in extending financial services to poor remote areas through mobile banking.

Among other financial institutions that provide access to financial services for the poor, three are especially notable: the state-owned pawnshop; cooperatives; and other micro finance institutions. Each has its peculiar impediments and possible solutions, which are discussed further below. Non-Bank Financial Institutions

(NBFIs) have made much smaller inroads in being relevant for the poor – although there has been some encouraging progress in a few areas in recent years, for example, in micro insurance and leasing.

Main Recommendations

Wider access to financial services by lower-income Indonesians needs both public and private sector interventions as well as some innovative public-private partnerships. The focus should be on broader access to financial services overall for the lower-income and poor as opposed to a narrow focus on access to credit. Credit is important for the poor, but savings requirements rank much higher. Much of the lower-income segments find existing financial products to be inappropriate to their needs. Designing and pilot testing appropriate products through partnerships could potentially open up more customers for the formal financial sector and vice versa, provide access to the formal financial system for a greater share of the Indonesian population.

From a public sector perspective, strengthening the existing legal and regulatory framework for various formal financial institutions would be a good first step in aiding the process. For every important service provider, there are aspects of the regulatory framework that could be eased for the sake of improving access to financial services, without compromising prudential safety.

For commercial banks, among quick regulatory winners, the most promising avenue is mobile banking, which holds considerable promise. Mobile banking holds great promise for reducing costs and extending reach – although, in line with international experience, it is likely to initially focus on payments services and remittances. The main economic issue of access concerns finding low-cost ways to deliver the services that lower-end consumers want. BI has recently made notable regulatory advances in this regard, but more is possible. For instance, non-bank service providers can issue e-money, but only for payment purposes. If they want to offer person-to-person services, they need a remittance license and eligibility requirements are currently an (unintended) barrier to entry. Simpler ways are available to accomplish the same regulatory purpose, without restricting entry.

To deliver mobile banking services cheaply, the economies of scale offered by a network of non-bank retail agents is vital. This would entail allowing banks the discretion to out-source services using a network of non-bank third parties, while holding the banks responsible for agent activities. For mobile banking to reach deeply into the 'financially excluded', there are also important KYC issues to be addressed. For example, simplified KYC requirements for low-risk, low-value accounts (and transactions) would permit the remote opening of bank accounts in isolated areas, and they would allow agents to facilitate the opening of new accounts.

Other smaller steps on commercial banks would also be helpful. For example, an official policy on dormant accounts might help reduce banks' monthly administration fees. Easier policies for banks to unilaterally close inactive, non-zero accounts could be offered to banks with institutional arrangements in place for the management of such accounts after they are closed. BI's recent agreement with major commercial banks to introduce basic banking – such as the proposed launch of a new saving product called "TabunganKu" (My Saving) in early 2010 – is also a step in the right direction. On bank reporting, annual business plans could be combined with the banks' annual reports, and elements of the business plan could be required only in fairly general terms. Regulations concerning relocations of branches and ATM machines look unnecessarily restrictive, and general descriptions of location should suffice. It would also be useful to ease official regulations on branching, at least to bring them into line with Bank Indonesia's current, relatively liberal approach to implementation.

Concerning BPRs, there are several regulatory barriers that could be eased to improve access, and Bank Indonesia currently seems to be re-thinking policy in this area. Consideration could be given to a lower tier of minimum start-up capital for small BPRs in remote locations; NGOs and foreign investors could be allowed to take some ownership positions in BPRs that are looking for capital. Reporting requirements could be re-examined for small BPRs in locations without adequate communications services. Written disclosure requirements could be waived in areas of low financial literacy, and replaced by oral briefings for new customers, including in the local language, where appropriate. In a step that also applies to commercial banks, Know Your Customer (KYC) regulations could be simplified for small accounts and requirements for taxpayer numbers waived for small loans below a pre-specified threshold. Moreover, for the sake of regulatory transparency, the current tight branching requirements could be brought into line with BI's liberal approach to implementation. To enforce regulations on BPRs, BI is already working hard to augment its capacity. As an additional interim step, BI might seek additional, temporary assistance by contracting firms that specialize in micro-finance.

Important regulatory steps could be taken concerning cooperatives, pawnshops and other microfinance institutions. *On cooperatives*, the most important issues appear to be prudential. These should be addressed on a sector-wide basis before any significant problems surface and potentially erode memberships' existing access to financial services. Concurrently, there needs to be an upgrading of the MCSME's regulatory and supervisory capacity. This could include temporary outsourcing of the function to firms specializing in micro-finance. Concerning *pawnshops*, the state-owned monopoly could be officially opened up to competition from the private sector – there are several privately run pawnshops operating anyway at present. In parallel, there needs to be a discussion on the extent to which these institutions needs to be brought under a formal regulatory umbrella, keeping in mind international experience. With regard to *other microfinance institutions*, the most productive way forward looks like restoring momentum to the drafting of a new Micro-Finance Law, and encouraging public debate on the issues during the process. It will be important that the new Law emphasize facilitation and access, taking into account emerging global experience regarding regulation and supervision of such institutions. In support, linkage programs between commercial banks and BPRs could be expanded to include non-bank MFIs, and it would be helpful if a similar role could be defined for NGOs.

For most forms of *insurance companies* a stronger foundation is needed for healthy expansion of this industry. The industry faces several fundamental structural issues that need to be addressed such as the existence of several weak and unviable firms before the industry can play a large role in expanding access. An important exception is the micro-insurance business, which is currently expanding rapidly, with the benefit of a successful public-private partnership. This could serve as a model for other products aimed at the lower-end of the income spectrum. There are also emerging models globally in this area that can be explored.

The report also addresses issues relating to MSMEs and migrant workers as special topics of interest to the Government at the time of the report. MSMEs' issues of access to financial services are virtually one-dimensional, that is, they are only credit-related, with problems of access mainly arising at the micro level. Indonesia has been pro-active in MSME finance policies for many years, but there is general dissatisfaction with results to date, despite large expenditures by the government. This is due in large part to the past emphasis, which has been on subsidized credit programs; in line with international experience, these have largely not been successful. The Government continues to make access to credit for MSMEs a major policy issue and has initiated the Kredit Usaha Rakyat (KUR) program as a means to consolidate the existing programs and put in place an integrated credit guarantee scheme to bring previously unbanked MSMEs into the formal banking sector. While a formal review of this program was underway at the time of writing of this report, the Government has also announced a significant scaling up of the program. Depending upon the results of the assessment, the government may consider strengthening the modifying/existing KUR program; it may also be a model approach to consider assessments of its other subsidized lending programs.

Migrant workers' issues are also high on the Government's agenda. From an access to finance perspective, this group should be of particular interest to financial institutions, given the large remittances that these workers send home. In general, in several areas, to assist migrant workers, Indonesia also could ask to re-negotiate the terms of its Memoranda of Understanding on Migrant Workers with recipient countries [3] aimed at better balancing the interests of the workers themselves with interests of employers and recruitment agencies. From the perspective of increasing access to financial services, specific points of negotiation could include acceptable forms of identification (which would not limit access to formal sector services) and exempting small transfers from formal identification requirements. To convince banks of the commercial value of this market, it might be useful to explore possibilities for innovative public private partnerships to bring greater segments of these workers into the formal financial sector. One approach may be wider use of domestic guarantors (or co-signers) for pre-departure loans to migrant workers. Development partners (or NGOs) with particular interests in these workers might consider acting as the guarantor in pilot projects that can then be examined for their scaling-up potential. Another could be design of innovative savings instruments that will permit these workers to save their earnings for use over a longer period of time. To lower obstacles presented by Know Your Customer regulations, it may be possible to negotiate minimum documentation requirements for small transfers, that will not be a risk to the global AML/CFT efforts, but that also enhance access for migrant workers.

The way ahead

A major government focus on enhancing access to financial services for the poor and low-income segments (as opposed to a narrow focus on access to credit alone) is essential if financial inclusion in Indonesia is to be significantly increased. Several developing countries have adopted policy statements and strategies in this regard. Access to finance is an issue that cuts across several stakeholders : the authorities such as Bank Indonesia, Bapepam-LK, Ministry of Finance, Ministry of Cooperatives and SMEs, etc. as well as the financial sector including state owned and private banks, non-bank financial institutions, as well as NGOs, foundations and think-tanks working in this area. Technology and education will play a key role in scaling up access rapidly – so actors such as telecom companies, academic institutions and financial literacy providers will also be important. To the extent useful, Indonesia's international development partners can provide knowledge and financial inputs. Working together it is possible to scale up access to financial services for a greater share of Indonesians and provide a sound basis for sustained poverty reduction.

3 A recent World Bank study makes several practical suggestions in this regard; see The Malaysia-Indonesia Remittance Corridor (2008a).