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Financial Technologies for the Informal Sector With Case Studies from Indonesia

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SOCIAL STRATEGIES FORSCHUNGSBERICHTE veröffentlicht Arbeiten über aktuelle sozialwissenschaftliche Problemstellungen. Im Vordergrund sollen Analysen und Lösungsansätze zu soziologischen und gesellschaftspolitischen Fragen stehen.

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Exchange rates, December 1985 - November 1989

		DM	US $
December	1985	448.2	1125.25
December	1986	844.2	1641.0
December	1987	1036.8	1650.0
December	1988	779.2	1729.0
November	1989	1005.2	1794.0

PREFACE

The poor in the informal sector of developing economies generate a large share of the goods and services, employment and income for the masses. By necessity, they have learned to rely on themselves and their own initiative. Self-help and self-reliance are strategies of their own making. These are strategies of survival and at the same time strategies of development from below.

Many obstacles are in their way. One of them is lack of finance. This is not the only bottleneck; but it is usually found to be a crucial one. For income-generating activities and for the development of micro-enterprises, the availability of adequate and sufficient finance is therefore a policy question of the utmost importance.

The core problem of financial markets in developing countries lies in their segmentation: Formal financial institutions provide too much finance to a select few; informal financial institutions provide too little finance to a great many. The former frequently do not get repaid; as a result, many banks are unsound and unviable. The latter have no problems with repayment; but the finance provided is insufficient as a booster to micro-enterprises.

Can the two worlds of finance be bridged? How can the poor utilize the capacities of both worlds? And for the poor to live, work and prosper in both words, who has to change first, the poor or the institutions?

What is presently needed is not further speculation on the topic. Sufficient experience to draw on exists for policies of financial services to the informal sector. What is of course always lacking is up-to-date information on the most recent experience. Indonesia is but one of many countries which may contribute to the wealth of existing policies. Its special importance lies in the fact that it is one of the few countries which, by way of deregulation since 1983, has created the right policy environment. In Indonesia, innovative financial technologies for the informal sector can flourish because they are unimpeded by the constraints imposed by interest ceilings, subsidies and other good intentions of misled policy makers.

There are three major strategies for the development of financial services:

- Finance with the poor,
- finance by the poor, and
- finance for the poor.

Operationally, they translate, in the Indonesian context, into

- linking formal and informal financial institutions (finance with the poor)
- upgrading informal institutions (finance by the poor) and
- downgrading banks (finance for the poor).

The issue at stake is not which one is better, but rather, how can each be best utilized for the benefit of the poor. Perhaps Indonesia has a few lessons to tell.

December 1989
Yogyakarta, Indonesia

PART I: FINANCE WITH THE POOR

LINKING FORMAL AND INFORMAL FINANCIAL INSTITUTIONS: AN ACTION PROGRAM IN ASIA AND THE PACIFIC

Summary

In the past, programmed credit, subsidies and neglect of savings mobilization have undermined rural finance. This has rendered financial institutions unviable and development unsustainable. In recent years, the number of countries has been growing in which banks mobilize savings and practice commercial banking. But due to excessive transaction costs for both banks and customers, they rarely reach down to the grassroots level. The rural poor therefore have to rely on informal financial institutions, which are viable, self-sustained and adjusted to local conditions. Yet their resources are insufficient for the local micro-entrepreneurs; they are too weak to reverse the trend of the rural-urban capital flow; and they alone cannot financially support a dynamic development process.

During the early 1980s, a novel approach entered into the debate: linking informal and formal financial institutions. In 1986, APRACA made the step from debate to action. Being an association of central banks and major financial institutions in Asia and the Pacific, it took the lead role on the international level, while its members initiated action on the national level. In the new approach, financial self-help groups act as intermediaries between micro-entrepreneurs and banks. This reduces transaction costs substantially, for the benefit of both: micro-entrepreneurs gain access to banks, while banks extend their services to low income groups. The strength of the APRACA initiative lies in the fact that the bottom-up movement of local self-help groups is met by the top-down approach of an association of leading banks.

Subsequently, member countries began to survey self-help groups, elaborated linkage models and prepared projects. Indonesia was the first to implement a pilot project. Bank Indonesia, Bank Rakyat Indonesia and the PVO Bina Swadaya formed a national task force, carried out studies and initiated processes of dialogue and participation among the potential partners, who in turn negotiated institutional linkages and financial terms among themselves. Technical assistance has been granted by Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH. In a favorable policy climate, a project was designed which incorporates the major factors of sustainability, such as reliance on institutional capacity, cooperation between governmental and private voluntary bodies, pre-existing grassroots organizations, domestic resource mobilization, market forces, scheme flexibility and sociocultural adjustment. It gives a push to self-supporting market processes between banks and SHGs of micro-entrepreneurs. During 1989, the first linkages between banks, private voluntary organizations and existing financial self-help groups were successfully implemented.

Contributions to this chapter by Dr. Uben Parhusip are gratefully acknowledged.

1. Old Fallacies and New Policies in Rural Finance

In most developing countries, policies of rural financial development have been based on **three fallacies** concerning their target groups: Rural micro-entrepreneurs are unable to organize themselves; they are too poor to save; and they need cheap credit for their income-generating activities or small enterprises.

Three financial policies resulted from these assumptions: credit-oriented development banks and special programs were set up which ignored savings mobilization; credit was subsidized; generous credit guarantee schemes were set up to cover anticipated losses.

The resulting consequences of these policies did not contribute to the self-sustained growth of rural finance, nor did they sufficiently benefit the rural poor:

a) Subsidized credit meant that the scope of credit remained severely restricted. There was no built-in growth factor which would have resulted from internal resource mobilization. The amount of credit was directly tied to the amount of subsidies available. Small numbers of relatively large loans went to medium and large enterprises. The masses had no, or little, access to institutional finance.

b) Banks were not motivated to give their customers a thorough screening and to recover their losses, while borrowers felt little motivation to repay their loans. This resulted in high default rates and in continuous program decapitalization.

c) Subsidies led to misallocation of production factors.

Around 1980, a **reorientation** set in among rural financial policy makers: mounting international debts, increasing shortages of internal and external credit supplies and a growing dissatisfaction with state nurtured and seemingly ineffective credit programs led to a rethinking, centering around such concepts as self-help, self-reliance, self-sustained growth and institutional viability. In terms of financial systems, this meant in particular an emphasis on savings mobilization as a prime mechanism of internal resource generation. As of then, development assistance was to promote, not to replace, self-help and personal effort.

It was then found that micro-entrepreneurs in developing countries may be poor; but they are able to save, and they are capable of forming their own self-help organizations. Yet, they usually face a number of **problems:**

a) Institutional finance is inaccessible to the large majority of micro-enterprises.

b) Concessionary financial programs for micro-enterprises have largely failed. Economically they are not viable; in terms of impact, they reach but a minute proportion of their target group.

c) There is a wealth of human, organizational and institutional resources. But as long as they are not mobilized and appropriately linked, their potential may remain untapped: Such resources include micro-enterprises, informal, semiformal and formal financial institutions, private voluntary organizations and governmental agencies and programs.

d) Conventional approaches to rural micro-enterprise finance face high transaction costs for both lenders and borrowers. At low interest rates they are unviable for banks; at market rates, they may be unviable for most of the potential borrowers.

e) Credit programs without a savings component ignore savings as a means of internal resource mobilization; at the same time, they ignore savings habits as a psychological basis for investment and repayment behaviors.

f) Confined to their own resources and membership and barred from access to banks, most self-help groups of micro-entrepreneurs have been unable to fully mobilize their potential. Operating outside the formal sector, they have tended to keep a near-stationary economy going and to contribute more to its stabilization than to rapid development.

A **core problem of rural finance** is that the existing institutional resources are not adequately utilized and that the financial services of the formal sector are therefore not available to the poorer sections of the rural population. **APRACA** and its member institutions are among those who decided that action was to be taken.

2. Lead Agency Roles in Asia and the Pacific

2.1 *The APRACA Program*

APRACA (Asian and Pacific Regional Agricultural Credit Association), an association of central banks, rural development banks and rural commercial banks, is one of four Regional Agricultural Credit Associations (RACA) originally promoted by the United Nations Food and Agriculture Organization (FAO). Established in 1977 with an emphasis on agricultural credit, it subsequently broadened its scope towards rural finance. At a workshop held in May 1986 in Nanjing, China, the member countries adopted a novel program of access to formal financial institutions for the poorer sections of the population. The innovative focus of this program is on ***a financial intermediation system built around self-help groups as grassroots intermediaries between banks and rural micro-entrepreneurs.***

Subsequently several APRACA members carried out surveys in their respective countries. They found that there are **many organizations and institutional resources** with great potential for micro-enterprise finance and rural development. What stands in the way of the full utilization of these resources is financial market segmentation. There are formal financial markets for the upper 5 to 20 percent of the population. These markets fall under the control of state credit and related financial laws and are supervised by the central bank. They comprise central, commercial, development, savings and secondary banks as well as non-banking institutions. In addition, there is a small but growing semiformal financial market, which comprises governmental and private voluntary organizations, so-called Self-Help Promoting Institutions (SHPI), with their own savings and credit programs. They do not fall under the state's credit law but operate with the approval of the state and its organs. Informal financial markets comprise financial self-help groups, other self-help groups with secondary financial functions and individual financial agents, such as moneylenders, deposit collectors and trade, crop or land related financial arrangements. From a policy viewpoint, financial self-help groups are of particular importance. They are found in most Asian countries and in most culture areas or ethnic groups within them. Their main financial functions usually are accumulation and depositing of savings, granting of loans and, to some extent, rendering of insurance services. They may be found in urban and rural areas, among traders and market-women, farmers and fishermen, craftsmen and small industrialists, wage and salary earners, and among bank employees. Though part of the informal financial sector are without legal status, most associations do possess organizational structure. Typically, they are headed by a staff of elected executives; they have written rules and regulations; they keep membership lists and they practice some form of book-keeping. Local social control mechanisms effectively prevent defaulting or fraud, which plague so many formal credit programs.

For more effective financial coverage of the poorer sections of the population, **three different approaches** have been discerned in the APRACA discussions on rural finance:

- **upgrading** financial self-help groups of micro-entrepreneurs;
- **linking** existing self-help groups and banks;
- adaptation of banks to their environment ("**downgrading**").

The participants decided on the **linkage program** as a focal approach which may eventually comprise both upgrading and institutional adaptation measures.

While the member countries are likely to recommend particular models of linkages which reflect the sociocultural and economic situation, the main emphasis is on the initiation of **processes of interaction and dialogue**.

These are to result in appropriate national and local activities to promote financial services for micro-enterprises.

In many countries, discussions have been held, and research has been carried out, on self-help groups and their importance for the development of rural finance. Yet, these discussions held on, or below, national levels have not resulted in national policies. It was only when the discussion moved to the **international level of APRACA** that it gained a new momentum.

Two types of **lead agencies** evolved:

- On the international level: APRACA as an association of central banks and national financial institutions with a rural mandate;
- On the national level: central banks, and some major rural financial institutions, as national policy makers.

Policies were discussed, and procedures worked out, of initiating the process of linking banks and self-help groups within the member countries. This provided the basis for **baseline research and policy discussions on the national level**, the results of which were fed back to the international level. Since 1986, there has been a continuous process of **communication** shifting back and forth between the international level and the respective national levels of the member countries. This dialogue provides the basis for a learning process which allows every country to benefit from the experience of the others. In addition to a variety of conferences, meetings and workshops, two instruments of communication and mutual learning deserve particular attention: one is an **international training program**, another one a new journal, **ASIA PACIFIC RURAL FINANCE**, published by APRACA (Maliwan Mansion, Phra Atit Road, Bangkok 10200).

2.2 *Guiding Principles*

APRACA members discussed essentials of a sound policy for financial market development. No unequivocal consensus was attained, but several **guiding principles** emerged from the discussion:

1. Working through existing formal and informal institutions. Existing formal and informal institutions are encouraged to cooperate. In particular, this comprises informal financial self-help groups (SHG), banks and PVOs or other Self-Help Promoting Institutions (SHPI). Program activities will not be geared at the establishment of new institutions; instead, there shall be an emphasis on upgrading existing institutional resources.

2. Promoting savings mobilization. Financial institutions shall be encouraged to mobilize rural savings in order to strengthen their internal resource base. There are two prerequisites for effective savings mobilization:

- For savers, who demand deposit facilities, savings shall not yield negative real returns (relative to the rate of inflation).
- For financial institutions, which supply deposit facilities, savings mobilization must not be "undermined" by cheap (i.e., subsidized) credit (D. Adams et al.) from the central banks or from donors. Thus the interest rate on liquidity credits shall equal the cost of mobilizing rural savings.

3. Promoting credit delivery at market rates. Financial institutions should be encouraged to apply market rates of interest in order to achieve a balance of the supply of, and demand for, credit in rural areas. Financial policy makers should be advised to create the conditions and regulatory framework for the application of market rates.

4. Linking savings and credit. Credit shall be linked to savings: no credit without savings, no savings without credit! Participating institutions may agree upon a savings-to-credit ratio, reflecting the credit-worthiness of the borrower.

*5. **Substituting group liability for conventional collateral.*** It is suggested that no other physical collateral will be requested over and above the savings deposited. For the remaining balance, the SHG will act as a joint liability group.

*6. **Ensuring institutional viability.*** As a basis for their institutional viability, all financial intermediaries involved - SHGs, PVOs and banks - shall cover their costs of intermediation through an adequate interest margin. Over and above costs of funds, intermediation costs include transaction costs, reserves for bad debts and costs of extension services.

*7. **Covering the risk from the margin.*** The risk of defaults shall be borne by the financial intermediaries themselves. External credit guarantees, though sometimes necessary for banks as an inducement to participate in an experimental phase, are seen as contrary to program sustainability and self-reliance.

The first APRACA countries to design pilot projects were Indonesia, Nepal, the Philippines and Thailand. In Indonesia, the pilot project started in 1988; Nepal, the Philippines and Thailand are expected to follow in 1989/90.

3. Linking Formal and Informal Financial Institutions: A Pilot Project in Indonesia

3.1 *Background*

The Republic of Indonesia surpasses most other developing countries in terms of population size (175 millions in 1988), geographical extension and ethnic or cultural diversity. The number of enterprises exceeds 30 million; more than 90 percent are micro-enterprises, mostly in the informal sector.

Until 1983, financial markets were tightly regulated. Since then, they have been gradually deregulated. Exchange rates are allowed to fluctuate according to the market. This has led to substantially higher levels of domestic savings mobilization. Interest rate restrictions have been removed; minimum reserve requirements have been lowered to 2 percent; the ban on establishing new banks has been lifted. Indonesia has now the highest interest rates in the region (e.g., time deposit rates from 16 to 24 percent) which has reduced capital flight.

For twenty years, the Government of Indonesia has experimented with financial schemes for small enterprises. Most of its credit programs were subsidized and had no savings component. Banks served mainly as channels for the distribution of government funds. They had little, if any, motivation to mobilize savings, to actively search for borrowers and, equipped with generous credit guarantee schemes, to scrutinize loan applications and enforce repayment. As a result, loan repayment performance was usually poor. Access of the masses of the population in rural areas, and even more so in the urban informal sector, remained severely restricted - with a negative impact on productive investments and income generating activities.

In the new era of financial market deregulation, disenchantment with subsidized programs, with their poor performance and their questionable effectiveness, has been growing, both in government and bank circles. They are now being gradually dismantled in Indonesia. The new **policy environment** encourages banks to embark on vigorous campaigns of **domestic savings mobilization**, to expand **credit delivery at market rates** and to experiment with **innovative approaches** to rural and urban finance.

The present financial market situation in Indonesia bears the marks of both old and new, regulated and free market policies. Financial markets are segmented into formal, informal and semi-formal financial markets. Banks are the core institutions of the **formal financial sector**. This sector also includes a number of small second-tier institutions, which are defined as nonbanks, such as BKK in central Java, LPD in Bali, LPN in West Sumatra and others, which are supervised by primary banks (in this case regional banks, BPD), as well as registered cooperatives (KUD and others), which fall under the cooperative law. There are numerous **informal financial institutions (IFI)** which operate without legal status and outside state control: money lenders, financial self-help groups (rotating and non-rotating savings and credit associations, unregistered credit unions) and numerous other groups with secondary financial functions. In terms of origin, they may be indigenous, state- or PVO-initiated, with considerable overlaps between these three categories. **Semi-formal financial institutions** include PVOs as well as GOs, which act as intermediaries between domestic or foreign donors and informal self-help groups or final individual borrowers. They are extra-legal in their financial activities, but so far have obviously enjoyed the tacit tolerance of the state. In addition, one may include officially recognized but unregistered pre-cooperatives in this sector.

There is a wide network of **institutional resources in Indonesia**. There are more than 15'000 bank and non-bank institutions offering financial services. There are a great many self-help groups (SHGs). Their number probably surpasses the one-million mark. They have generated their own funds from various sources and, as IFI, have built up their own savings and credit business. There is a small number of Self-Help Promoting Institutions (SHPI) which, acting as semi-formal financial institutions, have made substantial contributions to the development of a selected number of self-help groups in such fields as group formation, personal development, skill training, income-generating activities and finance.

Both informal and semi-formal financial institutions share a number of **shortcomings**:

- They are not linked to the banking sector, except, in some cases, with regard to fund depositing or transfer.
- They have no access to the refinancing facilities of the central bank; at best they depend, to a moderate extent, on external donors.
- They are restricted in their savings and credit activities due to shortages of funds.
- They have no access to bank training facilities; consequently they lack financial skill and banking experience.

3.2 *Objectives of the Linkage Project*

Despite substantial contributions made by the extension of the rural banking network and by special credit programs, rural finance has remained inadequate in providing for the growing needs of small enterprises and farmers, particularly among the poorer section of the population. Bureaucratic red-tape, lack of collateral and legal requirements have effectively barred the poorer sections of the rural population from banking services. In addition, there is one **obstacle** which may surpass all others in economic importance: **excessively high transaction costs for both banks and their customers**. Private money lenders have moved in to fill the void, charging interest rates which cover these transaction costs. At these rates, however, most micro-entrepreneurs find it difficult to use credit for the financing of their business, except in some fast turn-over trading activities.

Indonesia, together with other APRACA member countries, decided to carry out programs to **improve the system of rural finance available to the poorer sections of the rural population**. The initiative was taken by Bank Indonesia (BI) - the central bank - together with Bank Rakyat Indonesia (BRI) - the largest commercial bank with a rural mandate - and Bina Swadaya - a prominent PVO. After extensive consultations with

APRACA, FAO and GTZ, they jointly formed a national task force, commissioned a study of self-help groups to Gadjah Mada University (Prof. Mubyarto et al.) and worked out a linkage program. This was followed by intensive national consultations with numerous organizations. In a **pilot project**, a novel approach to the development of rural finance was to be tested, **linking existing self-help groups as grassroots intermediaries to banks for both savings mobilization and credit delivery,** thus **minimizing transaction costs** for both banks and final borrowers. The **project purpose** is that **viable financial services are made available to self help groups of micro-entrepreneurs and small farmers.**

3.3 *Project Outputs*

In order to attain the project purpose the following **outputs** are to be achieved by the project:

1. Project organization is set up and works effectively.
2. Processes of dialogue among participating and related institutions are established.
3. Institutional linkage models are worked out by the National Task Force.
4. Financial schemes are worked out by the National Task Force.
5. Institutional linkage models and financial schemes are adjusted and agreed upon by participating institutions.
6. Linkages are implemented on the local level
7. A training program is established and implemented.
8. Institutional development of participating institutions is initiated.
9. Monitoring and evaluation services are provided and are used as a management information system.
10. Research services are provided.
11. Preparation for project follow-up is concluded.
12. Project materials are published.

3.4 *Dimensions of Linkages*

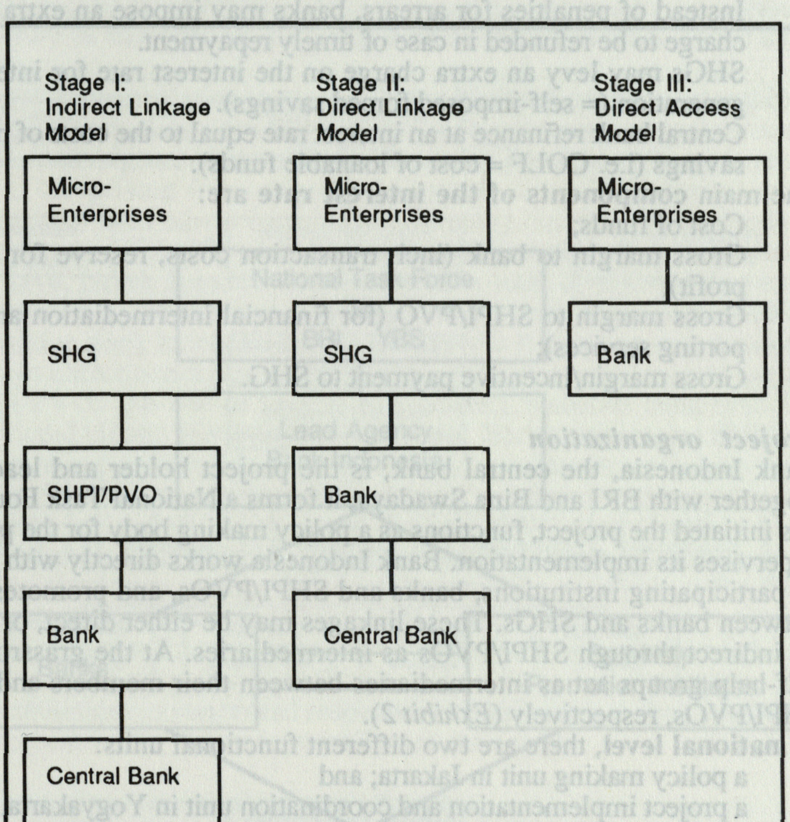
To implement the objective, the project is designed to **participatively initiate linkage processes,** rather than prescribe specific models. Any specific schemes are to be the outcome of participative processes among the respective participants. There are **two principal linkage dimensions:**

1. **Institutional linkages between SHGs and banks.** They may either be **indirect**, involving SHPIs/PVOs as financial intermediaries or as consultants, or **direct**. This is a novelty in Indonesia, and it is of particular interest to small rural banks which are short of funds and far from sources of refinance.
2. **Financial linkages between savings and credit.** In fixed ratios, the amount of credit is contingent upon the amount of savings. In dynamic ratios, the amount of credit increases with the number of successful repayment cycles - to ensure a gradual growth of the balance between credit and the borrowers' capacity to save, invest and repay.

On principle, these linkages are to be **self-sustained.** Therefore interest rates on savings and credit are market rates, and an adequate interest margin provides the basis for the institutional viability of each intermediary: bank, SHPI/PVO and SHG.

Institutional linkages between banks and SHGs may proceed in an **evolutionary sequence** of three steps, from indirect linkages to direct linkages, with the ultimate step of making the individual micro-entrepreneur bankable and giving him direct access (*Exhibit 1).*

Exhibit 1
Evolutionary stages of institutional linkages



Between these stages, there may be intermediate steps, with SHPI or SHG, respectively, in a consultative role. In addition, SHPI and various other agencies may supply supplementary technical and extension services.

3.5 *Financial Scheme*

Interest rates are worked out locally by the participating institutions. The project issues guidelines and recommendations which the participants are free to modify according to local conditions. Some major **recommendations** are:

- SHGs use part of their funds for internal lending, another part for depositing in a bank as a basis of refinance from the bank.
- Savings first: no credit without savings.
- Savings as partial collateral.
- Bank loans are group credit, to be onlent to members.
- Interest rates on savings and credit are market rates, taking into consideration reductions in bank transaction costs due to intermediary services of thirds.
- Joint liability as a substitute for physical collateral (on the balance not covered by the savings deposited).
- Ratio between savings and credit contingent upon credit-worthiness, primarily of the group and secondarily of the micro-enterprises, increasing over time with good repayment performance.
- Credit decisions for onlending to members by the group.
- Short-term credit up to 18 months.

- All intermediaries (central bank, banks, SHPI/PVOs, SHGs) are allotted an interest margin to cover their costs.
- Instead of penalties for arrears, banks may impose an extra incentive charge to be refunded in case of timely repayment.
- SHGs may levy an extra charge on the interest rate for internal fund generation (= self-imposed forced savings).
- Central bank refinance at an interest rate equal to the costs of mobilizing savings (i.e. COLF = cost of loanable funds).

The main **components of the interest rate** are:

- Cost of funds;
- Gross margin to bank (incl. transaction costs, reserve for bad debt, profit);
- Gross margin to SHPI/PVO (for financial intermediation and/or supporting services);
- Gross margin/incentive payment to SHG.

3.6 *Project organization*

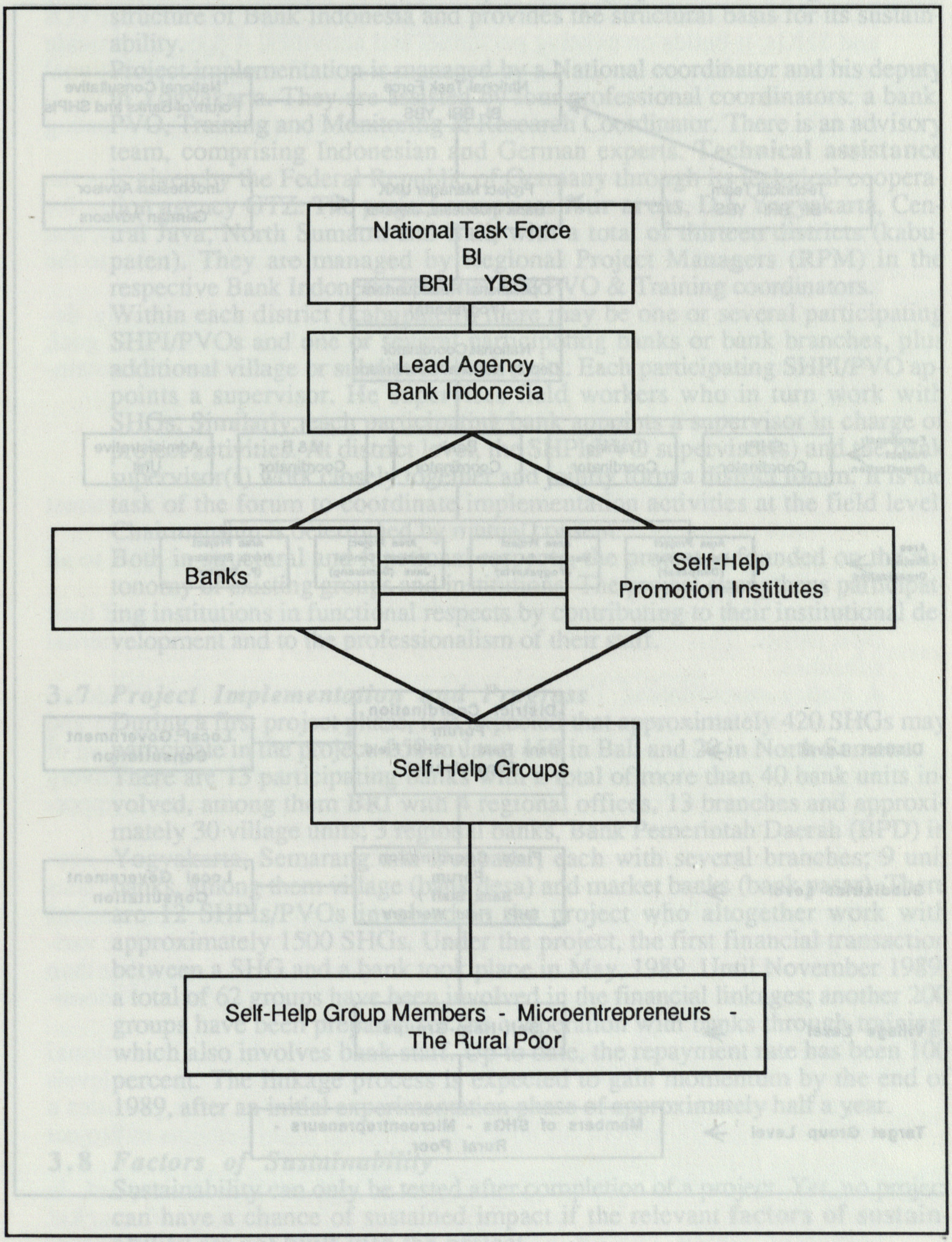
Bank Indonesia, the central bank, is the project holder and lead agency. Together with BRI and Bina Swadaya, it forms a National Task Force, which has initiated the project, functions as a policy making body for the project and supervises its implementation. Bank Indonesia works directly with two types of participating institutions, banks and SHPI/PVOs, and promotes linkages between banks and SHGs. These linkages may be either direct, or they may be indirect through SHPI/PVOs as intermediaries. At the grassroots level, self-help groups act as intermediaries between their members and banks or SHPI/PVOs, respectively (*Exhibit 2*).

At national level, there are two different functional units:

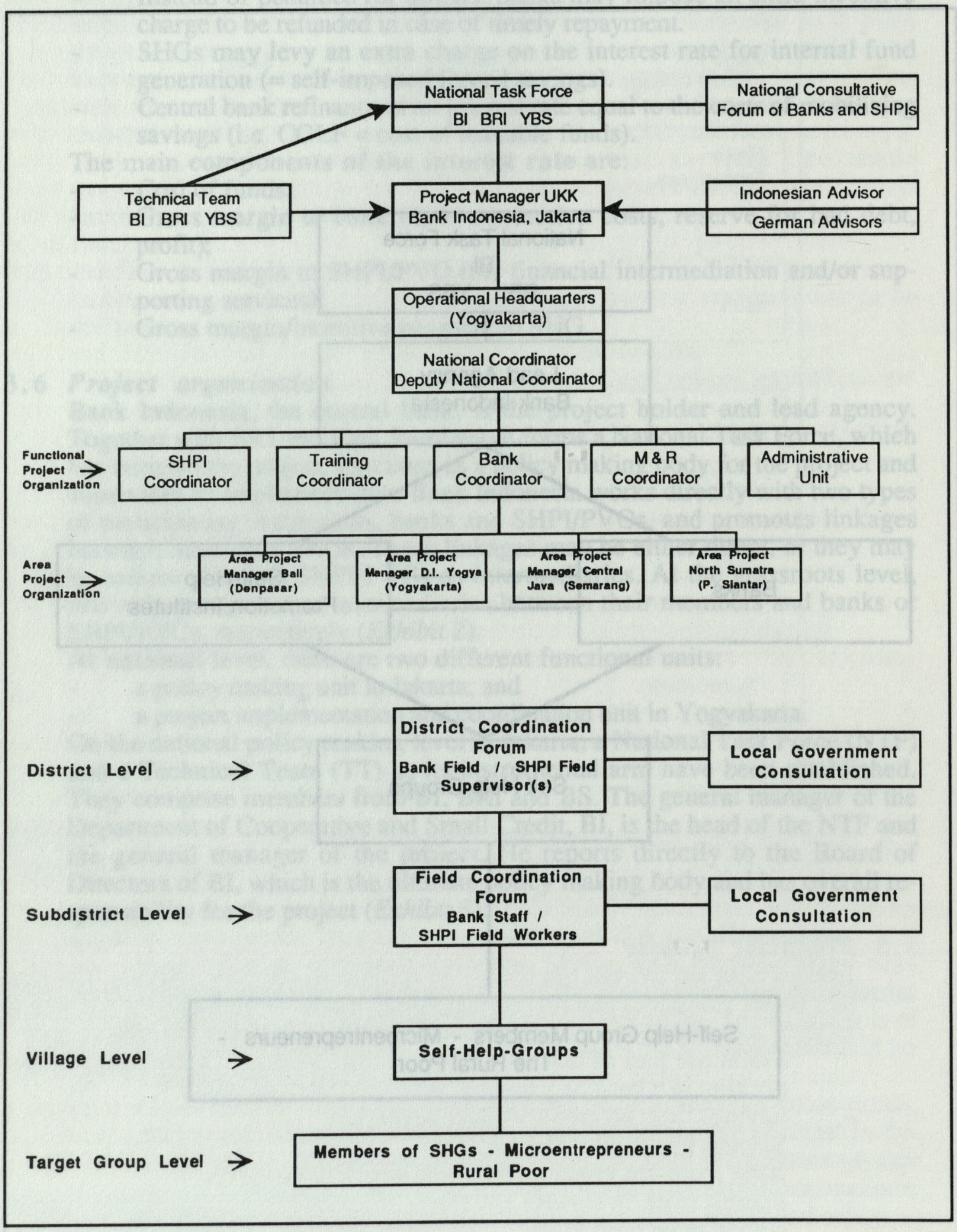
- a policy making unit in Jakarta; and
- a project implementation and coordination unit in Yogyakarta.

On the national policy making level in Jakarta, a National Task Force (NTF) and a Technical Team (TT) as its instrumental arm have been established. They comprise members from BI, BRI and BS. The general manager of the Department of Cooperative and Small Credit, BI, is the head of the NTF and the general manager of the project. He reports directly to the Board of Directors of BI, which is the ultimate policy making body and has overall responsibility for the project (*Exhibit 3*).

Exhibit 2
Project Design



Exhbit 3
Project Organization



A national **project implementation and coordination center** has been set up in Yogyakarta, where the project has been established as an organizational unit of BI (PPHBK). This places the project into the organizational structure of Bank Indonesia and provides the structural basis for its sustainability.

Project implementation is managed by a National coordinator and his deputy in Yogyakarta. They are assisted by four professional coordinators: a bank, PVO, Training and Monitoring & Research Coordinator. There is an advisory team, comprising Indonesian and German experts. **Technical assistance** is given by the Federal Republic of Germany through its technical cooperation agency GTZ. The project comprises **four areas**, D.I. Yogyakarta, Central Java, North Sumatra and Bali, with a total of thirteen districts (kabupaten). They are managed by Regional Project Managers (RPM) in the respective Bank Indonesia branches and PVO & Training coordinators.

Within each district (kabupaten), there may be one or several participating SHPI/PVOs and one or several participating banks or bank branches, plus additional village or subdistrict bank units. Each participating SHPI/PVO appoints a supervisor. He supervises field workers who in turn work with SHGs. Similarly, each participating bank appoints a supervisor in charge of project activities. At district level, the SHPI/PVO supervisor(s) and the bank supervisor(s) work closely together and jointly form a district forum. It is the task of the forum to coordinate implementation activities at the field level. Chairmanship is determined by mutual consent.

Both in structural and functional respects, the project is founded on the autonomy of existing groups and institutions. The project strengthens participating institutions in functional respects by contributing to their institutional development and to the professionalism of their staff.

3.7 *Project Implementation and Progress*

During a first project phase, it is expected that approximately 420 SHGs may participate in the project: 250 in Java, 150 in Bali and 20 in North Sumatra. There are 13 participating banks with a total of more than 40 bank units involved, among them BRI with 4 regional offices, 13 branches and approximately 30 village units; 3 regional banks, Bank Pemerintah Daerah (BPD) in Yogyakarta, Semarang and Denpasar, each with several branches; 9 unit banks, among them village (bank desa) and market banks (bank pasar). There are 12 SHPIs/PVOs involved in the project who altogether work with approximately 1500 SHGs. Under the project, the first financial transaction between a SHG and a bank took place in May, 1989. Until November 1989, a total of 62 groups have been involved in the financial linkages; another 200 groups have been prepared for the cooperation with banks through training, which also involves bank staff. Up to date, the repayment rate has been 100 percent. The linkage process is expected to gain momentum by the end of 1989, after an initial experimentation phase of approximately half a year.

3.8 *Factors of Sustainability*

Sustainability can only be tested after completion of a project. Yet, no project can have a chance of sustained impact if the relevant **factors of sustainability** are not **built into** the project.

1. Institutional capacity. The project is founded on the autonomy of existing organizations. In Bank Indonesia, it has a highly professionalized project holder with an immaculate reputation and a legitimate responsibility for the development of the financial system. The project is part of the line structure of Bank Indonesia and the participating banks. For its success, it does not depend on charismatic leaders. Routine personnel rotation is used as a means of providing training on the job to future project managers.

The project does not work through public administration bureaucracies. Its partners are institutions which work in the private economy. In banks, PVOs and SHGs, it builds on existing personnel and activities; it does not provide incentives to lure institutions into donor programs. Through its institutional development and associated human resource development components, it contributes to the planning and financial management capacity of participating institutions.

2. Motivation. To all participating institutions - banks, PVOs, SHGs - the linkages are expected to be profitable. This provides the basic motive for sustainability. They all have carefully examined, and proven over time, that they are able and willing to allocate personnel and financial resources to the project activities.

3. Project design for sustainability. The project is systematically designed towards sustainability. It is geared at a clearly defined single goal, i.e., giving SHGs access to banks. It includes essential elements of sustainability, such as,

- sociocultural and economic adequacy;
- working through preexisting institutions and structures;
- domestic resource mobilization as a source of fund;
- market processes in the the private economy, including market interest rates of savings, credit and bank refinance;
- ensuring institutional viability by providing an adequate margin to all participating institutions.

Participating organizations have accepted these elements on the basis of their own merits. This includes PVOs which previously depended on external subsidies.

4. Policy environment. The deregulation of financial markets in Indonesia since 1983 has provided the right policy environment for the project and its sustained impact. A deregulated financial system, a gradual dismantling of subsidies, vigorous efforts at domestic resource mobilization, credit delivery at differentiated market rates and openness to financial innovations are important policy factors bearing on the sustainability of the project approach.

5. Socio-cultural factors. The project builds on pre-existing socio-economic systems and grassroots organizations. In the project areas, it adjusts differentially to local cultural conditions, types of grassroots organizations and processes of decision-making. Its inbuilt flexibility to accommodate various and varying local conditions rests upon emphases on process rather than structure, on participation and communication rather than bureaucratic domination, on program openness rather than dogmatism.

6. International program dialogue. Through APRACA, the national project forms part of an international program dialogue on coordinated levels of policy makers, program planners and project personnel. This provides a communication framework for policy adjustments, improvements in project design and exposure training.

7. Self-supporting market processes. **A self-sustained impact is most likely if a project contributes to the functioning of market processes which should actually be functioning without intervention.** In this sense, the project provides an initial push to self-supporting market processes. It removes some obstacles and establishes contact between banks and SHGs of micro-entrepreneurs as business partners. It thereby creates an environment in which finance is available to the rural poor without continuous intervention.

PART II: FINANCE BY THE POOR

UPGRADING INFORMAL FINANCIAL INSTITUTIONS

1. Private Voluntary Organizations and Self-Help Groups Establish Their Own Banks in Indonesia

Summary

Financial markets in Indonesia are segmented into formal, informal and semi-formal markets. Private voluntary organizations (PVOs) which act as financial intermediaries form part of the semi-formal, financial self-help groups (SHGs) of the informal market. The activities of both are restricted by shortages of their scope of operations. PVOs and SHGs in Indonesia presently embark on two different routes to overcome these problems: one is through linkages with formal financial institutions, the other one through establishing their own banks. This chapter deals with the second approach. The latest act of deregulating the financial system, PAKTO 27 of October 1988 with amendments of March 1989, greatly eases the establishment of rural banks. Some PVOs and SHGs associated with them are now making serious efforts to take advantage of the new opportunities: by upgrading SHGs to banks, by setting up banks as apex organizations of PVOs or by forming joint PVO/SHG banks. This is expected to open up central bank refinancing facilities, to give access to the existing bank training institutes and to solve legal status problems. Ultimately, this is to make banking of the poor a growing, self-reliant and self-sustained industry - eventually independent of donor grants.

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1.1 *The Situation of Rural Finance in Indonesia*

In developing countries, there are usually two types of financial markets: formal and informal markets. In a number of countries, such as Indonesia, there is a growing third market, namely a semi-formal market. (For additional information, see Part I, Chapter 3.1.)

1.2 *The Situation of PVOs as Financial Intermediaries*

The **central problem** for the PVOs is their lack of a legal basis for their financial operations. Resulting from the central problem, PVOs face the following problems:

1. They have no access to the refinancing facilities of the central bank. As their own capital basis is usually weak, if not non-existing, the result is a dependency on funds from external donors. Most of the PVOs are not self-sustaining institutions.
2. They have no access to the facilities of bank training institutes. This results in a lack of proper financial skills and experience.
3. Their activities with regard to credit and savings schemes are always limited; certain schemes, such as the National Savings Scheme TABANAS, are not accessible to PVOs. The credit supply offered by PVOs to SHGs is invariably restricted and is far from fulfilling the need.

As a matter of fact, the primary emphasis of most PVOs is more on consciousness raising, personal development and skill training for group formation and income-generating activities and there is only a secondary emphasis on financial services. This raises a common dilemma for many PVOs: the more successful they are in their primary field of activity, the less likely they are to live up to their target groups' expectations for financial services.

There is now a number of PVOs in Indonesia which have been very successful in educating and training people from the poorer sections of the population and providing the skill to master their problems through their own self-help activities, both in terms of group formation and skills for income-generation. They have also assisted self-help groups in building up their own internal savings and credit activities. However, with every day, the gap widens between the capability of the PVOs' target groups to make good use of financial resources and the actual supply of such financial resources.

An increase in the supply of donor funds will temporarily solve the problem. However, permanent dependency on outside resources lacks the dynamics of self-sustained growth.

Ultimately, only the institutional development of PVOs and SHGs towards self-sustained financial institutions will generate the internal funds which are basic for the financing of income-generating activities. Such institutions will then have access to the refinancing facilities within the country, which may either come from within the banking system or from the central bank itself.

1.3 *A New Act of Deregulating Rural Financial Institutions: PAKTO 27*

On October 27th, 1988, the Government of Indonesia passed **'Paket Oktober 27' (PAKTO 27)**, a package of reforms for the financial and banking sector to advance the development of the banking system, to stimulate the mobilization of savings and to ensure an efficient allocation of these funds. Revisions were issued in March 1989. It is one of the objectives of PAKTO 27 to facilitate the establishment of small rural banks, **Bank Perkreditan Rakyat**, or **People's Banks**. Highlights of PAKTO 27 concerning the establishment and running of rural banks are the following:

1. Rural banks may be established in sub-districts (kecamatan) outside the capital, provincial capitals and municipalities.
2. A rural bank operating on subdistrict level shall have a paid up capital of at least Rp 50 million. A commercial or development bank on district (kabupaten) level shall have a paid up capital of Rp 10 billion.
3. Existing rural banks located in the capital, provincial capitals and municipalities shall either be promoted to commercial or development banks or else be moved to sub-districts. A transition period of two years is provided commencing from the issuance of the regulation.
4. A BPR is supposed to confine its business to the subdistrict in which it is located.
5. A rural bank may be registered under two different legal forms: either as a limited liability company (PT) or as a cooperative.
6. No licence is required from the Ministry of Finance for a rural bank to open a branch office located in the same subdistrict as its head office. It is sufficient to report the opening to the local Bank Indonesia branch.
7. A BPR is authorized to carry out savings and credit operations. It may mobilize funds in the form of demand, time and savings deposits and execute the Tabanas ('national savings' at 15% p.a.) or other savings schemes. Credits of these banks are to be mainly extended to small-scale entrepreneurs and the rural community.
8. As a safeguard to the soundness of banks, these institutions are subject to legal lending limits.

9. The distinction between primary banks, which are supervised directly by BI, and secondary rural banks, which were under the supervision of BRI, has been largely abolished. All banks are now directly under BI. This also means, that all banks, including the BPR, may now have access to central bank refinancing facilities.

1.4 *The Potential of PAKTO 27 for the PVO Sector*

PAKTO 27 has opened up new opportunities for PVOs and SHGs to set up their own formal financial institutions in the form of rural banks. This has the following advantages for the PVOs and SHGs:

1. For the first time in Indonesia, they now have the chance to leave the shadow economy of semi-formal and informal institutions and gain legal protection. The latter is particularly important in a political situation where the future of institutions without a sound legal basis of their financial and related operations cannot be secure.
2. On such a legal basis they may gain access to refinancing funds of the central bank. This could compensate their weak capital basis and reduce their dependency on external donors. Refinancing funds will be important for setting up self-sustaining and viable rural banks.
3. With formal banking status, PVOs and SHGs will gain access to the facilities of bank training institutes. This will lead to an improvement of their financial and banking skills.
4. By establishing new PVO/SHG banks at kecamatan level, the rural financial system may eventually experience a substantial expansion and improvement, particularly by providing financial services to the poorer sections of the population. For years PVOs have been active in rural areas with close contacts to SHGs and their members. Therefore, they are best suited to meet the financial needs of their target groups. Target-group oriented banking will also imply the adjustment of financial services to the rural population concerning banking procedures, savings and credit facilities, new products, opening hours, doorstep services, etc.

1.5 *Alternatives for the Establishment of PVO/SHG Banks*

PAKTO 27 was passed in October 1988 and revised in March 1989 with the objective of developing the Indonesian banking system. In particular, appropriate financial facilities should be provided for the rural population. Adequate financial services are regarded as prerequisites of economic development in rural areas. Setting up new rural banks by PVOs is therefore in harmony with the financial policies of the Government of Indonesia.

The ultimate target group are the rural poor, intermediate target groups are SHGs and PVOs, all of them in the private sector. These are target groups to whom high priority is accorded in international development policies, particularly among donor PVOs. As many international PVOs emphasize institution building around self-help and self-sustained development, the plan of establishing PVO/SHG banks, which in the medium and long run must be self-sustained, is in accordance with the principles of most international or foreign donor PVOs.

There are various institutional alternatives for PVO/SHG banks, depending on the arrangement between cooperating PVOs and SHGs (*Exhibit 4*).

Exhibit 4
Institutional Alternatives for PVO/SHG Banks

I a	Several SHGs → separate BPR	**Several SHGs separately form several BPR, each giving up their own informal status.**
I b	Several SHGs → separate apex- BPR	**Several SHGs separately form several BPR, simultaneously maintaining their own informal status for savings and repayment collection.**
I c	SHG, SHG → BPR ← SHG, SHG	**Several SHGs join together and form one BPR, giving up their own separate status.**
I d	SHG, SHG — apex-BPR — SHG, SHG	**Several SHGs jointly form one BPR and maintain their own separate status as informal groups, collecting savings and repayments for the BPR.**
II a	one PVO → apex-BPR	**One PVO forms a BPR as apex-organization with its own legal status.**
II b	several PVO → separate apex-BPR	**Several PVOs separately form several BPR as apex organizations with their own legal personality.**
II c	PVO, PVO — apex-BPR — PVO, PVO	**Several PVOs jointly form a BPR as an apex organization with its own legal status.**
III	PVO → apex-BPR → SHGs	**A PVO and several SHGs jointly form a BPR with its own legal personality; both PVO and SHGs maintain their respective organisational system.**

1.6 *Phases and Outputs*

There are four major **phases**:

Phase I: Examining the legal framework and legal procedures
Phase II: Examining the feasibility of PVO/SHG banks and working out an operational plan
Phase III: Preparatory activities, including staff training, preparations of the organizational set-up and procedures, location, equipment, provision of equity capital and provision of working capital
Phase IV: Start-up activities in the field
Phase V: The Working Phase.

To lay the foundations for setting up self-sustaining and viable rural banks, the following outputs will be necessary:

1. Consultancy services are rendered to participating PVOs concerning the feasibility and the viability of rural banks.
2. A feasibility report and a plan of action are worked out.
3. A project proposal is worked out.

1.7 *Conclusion*

Since 1983 the government of Indonesia has made new efforts to stimulate economic development by reforms in the economic and financial sector. On the whole, frame conditions for private enterprise as well as private organizations have been considerably improved by successive acts of deregulation. As the latest step, in October 1988, **'PAKTO 27'** was issued, a package which aims at the invigoration of fund mobilization and fund allocation by improving the financial system and further deregulating money and capital markets. Restrictions concerning the opening of new banks, branches or village units have been eased. For the establishment of a **rural bank operating at subdistrict (kecamatan) level**, equity capital of Rp 50 million (approximately US$ 28,000.-) is required. Provision has been made in PAKTO 27 for two different legal forms of rural banks (BPR): In the case of a limited liability company (PT), this capital may be raised from private investors; in the case of a cooperative bank, the capital may be raised in the form of paid-up savings of the members of the cooperative.

On principle, **PVOs and SHGs now have the chance to set up rural banks**, either separately or jointly, which may result in a **PVO/SHG banking network by the poor and for the poor**. In particular, many PVOs and SHGs who have not been operating under the benefits of formal financial institutions, may now seize the opportunity of placing their financial activities on a sound legal basis.

Rural banks established by PVOs/SHGs will thus serve **two different objectives**:

1. They will improve access of the rural poor to banking services.
2. They will provide a legal basis for the financial operations of PVOs and SHGs who otherwise may be threatened by an insecure future.

To effectively utilize the new potential of PVO/SHG banks, special skills and experience are required for **two different phases of development**:

1. **The start-up phase**: how to utilize the new legal framework; how to prepare the personnel for the new banks; how to raise the capital; and how to actually establish a new bank;

2. **The working phase**: how to train the personnel; how to set up the bank; how to manage the bank; how to structure relations between the new rural banks, the SHGs and the members of SHGs; how to structure relations between the rural banks and the rural population who are not members of the SHGs; and how to structure relations between the mother PVOs/SHGs and the rural bank as a separate legal entity.

Presently, PVOs and SHGs still lack the skills and experience required to establish and run a bank. Therefore, a plan of action is needed to overcome the shortcomings and initiate the process of establishing banks by the people and for the people. This includes an examination of the feasibility of rural banks to be established by PVOs, by SHGs, or jointly; and the working out of alternative models for establishing viable banks on a self-sustained basis. This is to contribute to the overall goal of improving the system of rural finance in Indonesia, particularly for the poorer sections of the population.

2. Lumbung Pitih Nagari: A Regional Program of Upgrading Financial Self-Help Groups in West-Sumatra

Summary

Lumbung Pitih Nagari (LPN) are savings and credit associations in West Sumatra, which are integrated into the regional banking system. They are informal financial institutions embedded into the formal financial system. They are the result of an upgrading process from two indigenous self-help institutions: one is the communal rice storage which used to exist in every Minangkabau village; the other one is Julo-julo, the ubiquitous rotating savings association (RoSCA). First attempts during colonial times at upgrading were interrupted by the outbreak of World War II. In the early 1970s, the provincial government began to refinance existing LPN through the Provincial Development bank, BPD, and at the same time to establish new LPN, one for every subdistrict. Two types of LPN emerged: those which were genuine self-help groups of indigenous origin and others, initiated by the Government, which were established for the main purpose of obtaining a loan. The former, approximately 40 percent of a total of 584 LPN, are financially successful, with repayment rates approximating 100 percent. Many of the latter exist on paper only. The lesson is quite clear: **self-help LPN** are of indigenous origin, rely mainly on their own funds, comprise active and reliable savers and borrowers and repay their loans on time; **government LPN** regard themselves as mere channeling agencies, are slow in generating their own funds, perform poorly as borrowers and become eventually inactive. The problem thus lies in their origins and definitions of identity, not in their links with banks. For both types of LPN are refinanced by BPD: the former to their benefit, the latter to everyone's detriment.

2.1 *Origin and History*

Lumbung Pitih Nagari (LPN) are village based savings and credit organizations in West Sumatra. The main ethnic group are the Minangkabau, which are known for their individualism, their commercial activities and, in terms of social structure, their matrilineal descent system. LPN are an interesting example of upgrading indigenous self-help groups to a financial intermediation system, linking self-help groups and banks.

LPN originate from two indigenous institutions. One is Lumbung padi, the communal rice storage go-down which every Minangkabau village used to establish for emergencies and for the support of poor people in case of need. Eventually, these Lumbung padi added other activities, such as marketing. For some time, contributions were in cash and kind (rice), until cash eventually dominated, and the rice storage turned into a village loan fund. The other precursor institution is Julo-julo, the ubiquitous rotating savings association, of which there are several in every village. These institutional origins contain several important elements: self-help in small groups, mutual aid on the village level, and a concern with poverty.

Before World War II, attempts were made by the government to strengthen and modernize these institutions but stopped when the war broke out. After the war, indigenous savings and credit activities continued to grow, and various kinds of groups emerged to which members contributed small amounts of savings to build up an internal loan fund. However, their financial activities were confined to the means of the members, and the lending volume remained limited.

In the early 70s, the provincial government decided to reorganize these group activities and provide a new impetus by linking them to the banking system. However, instead of simply refinancing the existing self-help groups, which appeared too small and heterogeneous, the government initiated the establishment of one LPN per Nagari (subdistrict), which comprises several villages. Ever since, small indigenous savings associations and government-initiated LPN have existed side by side, or the former within the latter. This means that, while the LPN built up its loan fund, subgroups within the LPN continued their rotating savings practices.

The main activity of the LPN was to accumulate members' savings and build up an internally generated loan fund. In addition, they were refinanced by the government and given access to the banking system, where they could deposit their savings and obtain loans for onlending to members. This was initiated by a one-off capital grant by the provincial government of Rp. 500,000 to each LPN and followed by allocations of Rp. 500 million and Rp. 1 billion to the regional development bank, BPD (Bank Pembangunan Daerah), by the Ministry of Finance. In addition, BPD would provide training, monitoring and auditing services and establish regular business relations with LPN.

As a result of strong promotional efforts of the regional government combined with the granting of a loan, LPN were established in virtually every subdistrict in West Sumatra.

Two categories of LPN emerged: those which were genuine self-help groups formed from pre-existing associations, such as Lumbung padi, Julo-julo and many others, and those that were newly created for the main purpose of obtaining a loan. Of the 584 LPN listed as per July 1987, only about 230, or 39%, were active, and a mere 133, or 23%, qualified for refinancing by the Provincial Development Bank. About 60% existed on paper only. In fact, internal reports of the BPD refer to "Self-Help LPN" and "others". "Self-Help LPN" tend to be of indigenous origin, to rely mainly on their own funds, to comprise active and reliable savers and borrowers, and to repay their bank loans on time. LPN which were established solely in response to the government's initiative and its credit offer tend to be slow in generating their own funds, of delaying payments and of defaulting, and sometimes of misappropriating funds; eventually, most of these LPN seem to have become inactive.

The number of LPN grew from 10 in 1972 to 584 in 1987. Membership is now around 60,000. 90% of the LPN are in rural and 10% in urban areas (cf. *Table 1*). About 230 of the LPN are active; the remaining ones are still registered, but no longer carry out regular savings and lending activities. 133 LPN meet the stringent criteria of, and are refinanced by, the BPD.

Table 1: Number of LPN and their members in West Sumatra, 1972 - 1987

	Number of LPN		
Year	Approved	Registered	No. of members of registered LPN
1972	10	-	-
1973	10	10	-
1974	40	40	1,533
1975	140	93	5,372
1976	140	136	8,347
1977	285	212	11,478
1978	392	314	19,599
1979	472	395	27,305
1980	552	452	32,128
1981	561	512	34,315
1982	561	538	43,817
1983	562	543	46,237
1984	564	548	47,654
1985	570	559	63,726
1986			58,895
1987	584	-	-

2.2 *Legal Status and Organizational Structure*

98% of the LPN are registered with the provincial government and enjoy a recognized legal status within West Sumatra. Their registration certificate (SK - Surat Keputusan), though not recognized under national law, gives them legal status and allows them to enter into business relations with banks.

LPN are non-rotating savings and credit associations of up to about 200 members covering one or several villages within an sub-district. They have two major functions:

- They provide a deposit facility, based on a system of self-imposed forced savings.
- They provide a credit delivery system based on internally generated funds and partially refinanced by the Provincial Development Bank.

A primary concern of the LPN is to provide finance for members' micro-enterprises, approximately 90% of them in rural areas.

An LPN is headed by a managing director, two assistant managers, and five supervisors. The managing director is elected for a four-year term by the general assembly of the LPN and confirmed by the Governor. There are annual general meetings in which elections take place. To keep administrative costs low, LPN usually operate out of the office of the village head. Only a few very large and well-to-do LPN are encouraged to acquire premises of their own.

The Minangkabau are a matrilineal society in which daily life is still governed by the adat, or common law. Matrilineal family and clan units are at the basis of group solidarity. They strongly influence individual behavior, property and usufructual rights. They monitor borrowing, lending and repayment and provide mechanisms of dispute management. LPN, which are part of the adat, follow its rules and practices, which is more difficult to accomplish for formal financial institutions.

2.3 *Savings Mobilization*

LPN depend mainly on their own resources, reinforced by some outside funds. Main sources of their funds are:

- a loan from the provincial government of Rp. 500,000 in 1974, Rp. 475,000 of which had to be repaid while Rp. 25,000 were a grant to build up an equity base;
- compulsory savings, amounting to 10% of every loan disbursed;
- general savings, comprising mostly monthly contributions of about Rp. 500 per member, the actual amount and cycle being determined by each LPN at its own;
- reserves, generated from accumulated profits;
- annual profits;
- loans from BPD.

Most Minangkabau question the value of monetary savings, which carry a low, if any, yield. They therefore prefer to keep their savings in gold, and many payments for real estate and the like are in fact effected in gold. The only attraction in savings is the expectancy of a loan. The ratio of LPN voluntary to compulsory savings is therefore approximately 1:13.

In December 1985, internal funds amounted to Rp. 2.03 bn, 57.6% of which were derived from members' compulsory deposits, 4,5% from voluntary savings, 18.3% from reserves and 19.6% from current profits. Between 1974 and 1985, the proportion of internal funds over total capital increased from 19.4% to 65.9%. Total capital in 1985 amounted to Rp. 3.07 bn, two-thirds of which were derived from internal funds. These figures are based on the total number of 559 registered LPN, regardless of their level of activity (*Table* 2).

Table 2:
Funds of LPN in West Sumatra, 1974-1985 (in million Rp.)

Year	Internal Funds					External Funds	Total
	Savings Deposits		Reserves	Transfers from current profits	Total internal funds		
	Compulsory	Voluntary					
1974	2.3	0.03	0.06	2.00	4.28	20.0	24.82
1975	14.00	0.26	1.05	12.29	27.60	46,50	74.10
1976	32.44	0.76	5.72	22.96	61.88	68.0	129.88
1977	55.64	1.64	12.48	36.19	107.05	83.67	190.72
1978	94.87	3.19	23.48	60.21	181.75	121.24	302.99
1979	159.74	6.82	44.28	94.67	305.51	150.35	455.86
1980	250.85	7.61	73.31	138.00	496.77	174.10	643.87
1981	338.00	11.51	118.91	165.59	164.01	207.51	841.52
1982	515.30	39.03	227.02	196.18	976.53	232.43	1'209.27
1983	646.58	40.32	275.35	217.69	1'179.94	349.43	1'529.37
1984	872.03	61.58	333.52	305.45	1'572.58	742.90	2'315.48
1985	1'166.97	91.29	371.30	397.87	2'027.43	1'047.39	3'074.82

2.4 *Credit Delivery*

Lending to members: The loan portfolio of LPN to members in West Sumatra grew from Rp. 11.9 million in 1974 to Rp. 2.5 bn in 1985 (*Table 3*).

Table 3
Loans of LPN in West Sumatra, 1974-1985 (in million Rp.)

Year	Fully paid	Doubtful	Bad Debts	Total
1974	11.91	0.02		11.93
1975	44.70	1.74	-	46.44
1976	70.97	9.58	-	80.55
1977	102.42	18.98	0.62	121.42
1978	168.69	34.28	0.39	212.15
1979	272.41	65.95	0.66	339.02
1980	365.28	114.16	1.72	481.43
1981	462.19	119.63	2.17	633.99
1982	638.93	120.55	205.47	964.95
1983	835.29	163.77	253.59	1'252.65
1984				1'916.16
1985	1'753.87	213.03	566.00	2'532.90

The maturity of loans to members is mostly between 6 and 8 months, up to a maximum of 12 months. The interest rate is 10% flat for 6 months or 20% per annum, calculated on the basis of the nominal amount of the loan. Instalments are mostly fortnightly, sometimes monthly. The effective interest rate is thus approximately 40% p.a. Loans vary mostly between a minimum of Rp. 10,000 and a maximum of Rp. 1 million.

Loan approvals are given by the LPN management, which is autonomous in its decisions. This includes LPN which are refinanced by BPD. The bank operates on the assumption that the group is better able of judging a borrower's credit-worthiness and the worth of the project to be financed than a bank's credit officer. It increases repayment rates, as the group is able to apply local social sanctions to defaulters, and it keeps bank transaction costs low.

Annual profits of LPN are allocated as follows: 45% are distributed as dividends among members according to their respective savings; 20% each are allocated to LPN reserves and to a village development fund, respectively; and 5% each are paid to the manager, to LPN staff, and to an LPN social fund, respectively. According to data submitted by 543 LPN as per March 1987, profits of the fiscal year 1985/86 were Rp. 278.5 million. Accumulated reserves amounted to Rp. 284.1 million, which was 95.3% of total capital.

In reviewing a loan application, the LPN management usually takes into consideration the following criteria:

- length of membership
- amount of savings of applicant
- loan purpose and viability of project to be financed
- financial strength of LPN.

Ten percent of the loan volume are retained as compulsory savings.

On principle, loan purposes are limited to income-generating activities and small-enterprise financing. Due to the fungibility of money, loans may sometimes be used for other purposes, such as education, marriage, funerals, pilgrimages to Mecca, which are all socially recognized. But generally, group cohesiveness and internal social control make for rather close adherence to the regulations of the LPN. Given the preponderance of commercial activities among the Minangkabau, most of the lending goes into the trading sector. According to 1983 data, 60% of the loans go into trading, 25% into crafts and small industries, and 15% into agriculture. Group projects, community enterprises and long-term investments have not been financed under the LPN program. LPN have legal status under West Sumatra provincial law and are linked to the Provincial Development Bank BPD where they deposit their equity capital and their savings. BPD in turn is refinanced by the Ministry of Finance, from which it received Rp. 1.5 million for onlending to LPN.

BPD loans to LPN are heavily subsidized. The effective interest rate is 7% p.a. An LPN may obtain up to 3.5 times its deposits in loans. In addition, it has to meet certain eligibility criteria, such as adoption of a book-keeping system, regular savings activities, training of LPN management, and auditing by BPD. Only 133 LPN have qualified for BPD loans; and as per July 1987, Rp. 1.38 bn had been approved, of which Rp. 1.18 had been disbursed; of the latter amount, 69% were outstanding as of July 1987, while 31% had been repaid.

Within the framework of a regional development project, the Area Development Project (ADP) in West Pasaman, the government of the Federal Republic of Germany has made funds available to the BPD for onlending to LPN, and it has given training assistance to LPN management. Starting in 1983, this has brought the total number of LPN in the area from 3 to 14. The LPN in this project are "Self-Help LPN" which started from pre-existing informal groups.

As part of its program of developing rural financial institutions, USAID has started an assistance program to LPN as of 1986, with a particular emphasis on book-keeping courses for LPN staff.

2.5 *Performance*

The performance record of LPN is mixed. The experience with "Self-Help LPN" is very good. An example is LPN Air-Bangis, with a repayment rate of 100.0%. Those LPN which were initiated by the government and set up by members for the sole purpose of obtaining cheap government loans have been doing poorly. In fact, about 60% of the LPN fall into this category and exist on paper only. Statistics collected and published regularly by the BPD lump data on these two groups and do not distinguish between active and inactive LPN. Bad debts are carried on in the books and not written off. Of the total amount of loans outstanding in 1985, amounting to Rp 2.53 bn, 69.2% were classified as fully paid, 8.4% as doubtful and 22.4% as bad debts (*Table 3*). Those 133 LPN which are being refinanced by BPD and which are viable self-help groups have given Rp. 2.1 bn in loans outstanding to members as per March 1987. Arrears as of that date were 8.9% of outstandings, and the repayment rate is expected to be around, or better than, 98%.

At the same time, LPN have been quite successful in savings mobilization: of the amount of loans outstanding in 1985, 80.0% were financed from internally generated funds.

In evaluating the strengths and weaknesses of the LPN program, a sharp distinction has to be made between the active part of the LPN in West Sumatra, which are usually "Self-Help LPN", and the inactive part, which continue to lead a paper existence in the official statistics of the BPD.

Strengths of the active LPN include

- a sound self-help group basis, providing an effective financial intermediation system at the grassroots level;
- based on indigenous institutions and integrated into the local culture;

- providing local deposit facilities directly accessible at minimal transaction costs;
- providing a system of quick, easy and convenient local credit delivery;
- with an emphasis on short maturity loans;
- high degree of self-reliance by mainly using internally generated funds for loans to members;
- direct local credit supervision by LPN management;
- using social controls which are part of the local common law;
- provincial legal status which gives self-help groups legal personality;
- linkages to banks as deposit and refinancing institutions;
- provision of technical services by bank.

Weaknesses of the LPN approach include

- promotional activities by the provincial government which ignore the principles of a sound self-help group basis and financial self-reliance;
- offering a start-up loan before groups had proven their capability to save and their financial viability;
- providing subsidized refinancing, which limits the scope of the program, tends to ignore sound banking principles and may lead to factor misallocations;
- large number of inactive LPN, which have ignored the principles of self-help;
- inactive LPN are carried on in official statistics, and performance data are not differentiated according to active and inactive status of LPN;
- bad debts are not written off;
- lack of overall rehabilitation program;
- lack of impact data.

In short, about 40 percent of the LPN are successful, financially self-reliant self-help groups, providing a financial intermediation system with commercial rates comprising both savings and credit activities at the grassroots level. About half of them have demonstrated the viability of linkages between self-help group and banks.

On the other hand, the experience of the remaining 60% of inactive LPN indicates that government pressure to organize in groups combined with offers of subsidized credit are not likely to initiate processes of self-help and self-reliance and do not lead to a viable financial intermediation system.

Table 4
Summary data on LPN, West Sumatra

Name	LPN - Lumbung Pitih Nagary
Type	Self-help groups, refinanced by the Government
Operating Unit	LPN - Local savings and credict association
Refinancing Unit	BPD - Regional Development Bank
Scope	Regional: West Sumatra
Starting Date	1973
Outstandings 1985 (million US$)	1,54
Maturity	6-12 months
Effective interest rate	40% p.a.
Recovery rate	
- all LPN	77.6%
- LPN refinanced by BPD	98,5%
Effective refinancing interest rate	7% p.a.
Internal resource mobilization	67.3% of total liabilities

PART III: FINANCE FOR THE POOR

DOWNGRADING FORMAL FINANCIAL INSTITUTIONS OR: INSTITUTIONAL ADAPTATION OF BANKS TO THE RURAL ENVIRONMENT

1. A Poor Man's Bank: The BKK Program in Central Java

Summary

BKK is a program of rural finance which demonstrates with overwhelming success how market rates can be introduced in a controlled policy environment which prohibits such rates. At the same time, it provides an example of institutional viability, impact broadening and sustainability.

BKK is a credit program under the provincial government in Central Java operating through 497 independent small delivery units. Each BKK is owned by the local government of the subdistrict (kecamatan). It is supervised and refinanced through the Provincial Development Bank, BPD, in Semarang. Technical assistance is provided by USAID. Loans are small, short-term and at commercial rates. Overhead costs are minimal. There is usually a team of three employees, each paid about Rp. 30, 000 per month (US$ 17), located rentfree in the subdistrict head's office. It was launched in 1970 and started operations in 1972 - at a time when the financial system of Indonesia was highly regulated, with interest ceilings fixed by the government and a general preponderance of subsidized credit financed from oil revenues. It is supervised and refinanced by a primary bank, BPD. Through this channel, it has received initial support from the Ministry of Finance which is the ultimate policy authority in the formal financial system. Yet, as a special program, it is not considered part of that system and therefore does not fall under the control of the credit law. It was therefore free, from its inception, to set its own terms, which were a multiple of the official subsidized rates. While its direct savings component has been weak, its main mechanism of internal resource mobilization has been through its high interest rate, part of which is plowed back into the reserves and contributes to the growth of the loan fund.

BKK is considered one of the most successful programs. From 1972 to December 1986, a total of 4.8 million small and very small loans were given. The repayment rate, in terms of the total value of all loans given during that period, has been 98.8 percent. From the interest margin, BKK has covered its costs of funds, administrative expenses and default losses; it has financed the program's growth; it has allowed a substantial build-up of reserves from retained earnings; and it has provided a source of income to the subdistrict. Above all, hundreds of thousands of small farmers, tenants and micro-entrepreneurs have had access to finance: "mudah, cepat dan tepat - easy, fast and adequate".

1.1 *Origin and Organizational Structure*

Badan Kredit Kecamatan, BKK ("Sub-District Credit Institution") is a regional program in Central Java under the provincial government, supervised and refinanced by Bank Pembangunan Daerah (BPD), the regional development bank. Launched in 1970, it started operations in 1972. It comprises 497 independent BKK subdistrict units (3/1987), practically one in every subdistrict (kecamatan), which give "easy, fast and adequate" small short-term loans at commercial interest rates, predominantly to small enterprises engaged in off-farm, income-generating activities. For the first ten years of its existence, the program had the status of a project, until 1981 when, by a provincial law, it was turned into a BUMD, Badan Usaha Milik Daerah, a profit-making and taxable corporation owned by the provincial government. It now receives assistance from USAID as part of its Financial Institutions Development Project. The program was set up to avoid the shortcomings of other existing credit programs, which worked with subsidized interest rates, used ineffective screening procedures, disbursed credit in single large amounts, worked under a centralized administration, and as a result of high transaction costs and high default rates, were quickly decapitalized and lost their financial viability. Like most of the other programs, it is run by a government institution.

The BKK program was capitalized in 1972 with a Rp. 200 million ($ 476,190) loan from the Central Java Provincial Government through the BPD, the provincial bank, to the BKK units. The three-year disbursement of the funds began with 200 BKK and grew to 486 BKK in 1975, which is 99% of all sub-districts in Central Java. Each BKK received a three-year, Rp. 1 million ($ 2,381) loan at 1% p.m. with a one-year grace period on the repayment of the principal.

Each BKK is an independent sub-district credit body that is locally administered and financially autonomous. The Governor of Central Java presides over the program, but operational responsibilities are delegated through district commissioners (bupati), in rural areas, or mayors (walikota), in municipalities, to sub-district chiefs (camat), where the actual administrative authority lies.

Between BKK units within one district, liquidity transformation takes place through a system of interlending along commercial lines.

Financial supervision lies with the provincial development bank, BPD, which has also supplied a unified system of book-keeping formats and procedures and is in charge of BKK staff training.

BKK are staffed with employees form the sub-district in which they operate, and they may lend only to sub-district residents. Most lending is done through 2,778 village posts, thus "taking the bank to the people", usually on market days. This keeps borrower transaction costs at a minimum. The goal is to have at least one village post for every two villages, i.e. approximately 4,200 posts.

Each BKK operates with a minimum staff of two, a book-keeper and a cashier. The total number of staff members is 1,740. In 1986, each staff member has given on average 302 loans totalling Rp. 15.90 million.

On principle, BKK staff are paid from income received from interest on loans. The fixed salary is relatively low, but it is augmented by an incentive scheme, Jasa Produksi (JAPROD), based on a BKK's performance, which is one of the great attractions and a powerful motivator; about 10% of quarterly profits are given as a bonus to employees, based on salary grade, with downward adjustments for one-third of the staff who are better-paid civil servants. There is no ceiling imposed, and employees may more then double their fixed salary.

1.2 *Credit Delivery*

Individual BKK units are refinanced by the regional development bank BPD. BPD's lending is based on a BKK's performance classification, unprofitable BKK are penalized by having lower credit ceilings. The classification is based on six factors: total equity ratio of villages to village posts, number of new borrowers, portfolio quality in terms of the ratio of number of payments made to number of payments due, total savings and capital circulation. Mostly as a result of a rehabilitation program, the proportion of BKK in one of the two best-performing classes, out of a total of five, has increased from 13.8% in 1981 to 21.0% in 1982, 32,9% in 1983/84, 41,7% in 1984/85 and 48.8% in 1985/86; by 31/12/1986, it had reached 55.1%.

Loans are for 22 days to 6 months, with interest due and compulsory savings paid before any principal instalments. All payments are in equal amounts, according to one of six repayment plans chosen by the client (*Table 5*).

Table 5
Types of BKK loans

Loan Type	Instalments	Payback period	Loan interest rate (per month) Nominal	Maximum	Savings rate	Total interest and savings
Harian	daily	22 days	4.8	10.8	6.5	10.0
Pasaran	every 5 days	60 days (12 pasar)	4.0	6.9	12.0	20.0
Mingguan	weekly	12 weeks	3.6	6.9	10.0	20.0
Bulanan	monthly	3 months	3.3	5.3	10.0	20.0
Lapanan	every 35 days	175 days (5 lapan)	3.4	5.6	20.0	40.0
Musiman	seasonal	6 months	2.0	2.2	10.0	22.0

Harian and Musiman loans are rare, the former because of a lack of daily collection facilities, the latter because of low yields of the program and its staff. There is a modest compulsory savings component, amounting to between 6.5% and 20% of the loan. BKK does not offer deposit facilities for voluntary savings.

Lending procedures to individual borrowers are geared at maximum simplicity and speed while minimizing risks. Main characteristics of BKK's lending policy are

- emphasis on productive rather than consumptive loan utilization, predominantly for off-farm activities;
- decentralized approval authority: BKK approval for loans up to Rp. 25,000, sub-district chief approval for higher loans;
- gradually growing loans to clients, beginning with small loans and slowly increasing the ceiling, based on past repayment performance and savings;
- lending from village post or sub-district office, whichever is more convenient to the borrower.

BKK follows a "graduation policy" by encouraging clients to eventually "graduate" from the BKK and directly borrow amounts exceeding the ceiling of Rp. 200,000 from the BPD.

Loan ceilings are Rp. 200,000 ($ 122) and may soon be increased to a maximum between Rp. 500,000 and 1 million. Average loan size in 1986 was Rp. 52,600 ($ 32).

Nominal interest of the four main loan types (Pasaran, Mingguan, Bulanan and Lapanan - cf. *Table 6*) are between 3.4% and 4.0% per month. The calculated effective interest rates are between 5.3% and 6.9% per month; but in actuality they are somewhat lower, because loan maturities are frequently exceeded, and not all BKK units levy a penalty. In fact, penalties on late payments are officially not part of the BKK program; but many BKK units have started to impose some charge, which is yet to be systematized.

The BKK has a compulsory savings component, which is more for educational than for fund-raising purposes, its main sources of funds being its own profits and reserves. By December 1986, compulsory savings stood at Rp. 2.48 bn, accounting for 14.9% of all liabilities.

The BKK program has experienced tremendous growth since its inception. From 1972 to 12/1986, a total of 4.83 million loans have been given, totalling Rp. 138.37 bn (cumulative value).

By December 1986, loan outstandings amounted to Rp. 15.06 bn. Profit during that year amounted to Rp. 2.25 bn. The annual loan turnover ratio on recent years has been between 2.2 and 2.4. During the fiscal year 1985/86, more than half a million loans were granted (525,576), amounting to Rp. 27.66 bn. (*Table 6*). Until 9/1987, about 50,000 new loans were given every year.

Table 6
Savings and loans of BKK in Central Java, 1984-1986, and cumulative realization, 1972-1986

	1984	1985	1986
Loan outstandings per 31/12 in bn Rp.	9.42	11.94	15.06
Compulsory savings per 31/12 in bn Rp.	1.79	2.16	2.48
Income from interst payments in bn Rp.	2.57	3.15	3.83
Profit in bn Rp.	1.71	1.98	2.25
Total assets in bn Rp.	10.74	13.26	16.62
Loan outstandings per 31/3 in bn Rp.	6.58	10.21	12.62
Total turnover of loans in fiscal years 1983/84, 1984/85, 1985/86	15.62	22.12	27.66
Annual loan turnover ratio	2.37	2.17	2.19
Total number of loans during fiscal year	385.200	474.464	525.576
Cumulative realization 1972-1986:			
Number of loans in millions	.	.	4.83
Amount in bn Rp.	.	.	138.37

1.3 *Impact*

Data are based on a study of 662 BKK clients in November-December 1982, by Goldmark & Rosengard (1983). 60% of clients in the sample were found to be women, who dominate the petty trading sector. As their primary economic activity, 53% stated trading, 15% agriculture, 12% services or repair crafts, 11% handicrafts and 7% agricultural processing. Agriculture was given as a secondary activity by 54% and trading by 29%. Of the rural clients, 60% owned and 6% rented land only; of the urban clients, 25% owned or rented land. 58% had no or little primary education. 34% of clients had received additional loans from other sources. Most prominent among these were indigenous savings and credit associations, arisan and simpanpinjam, accounting for 32% and 5% of all loans, respectively. Other loans from informal financial institutions included moneylenders (5%) and land- or crop-related loans (13%).

The average BKK loan in the sample was Rp 59,000 ($ 88 by 1982/83 exchange rates), which was 77% higher than the overall BKK average. Borrowers in the sample had received an average of 13 consecutive loans from the BKK. Most popular in rural areas was the Mingguan loan with its weekly repayment schedule, usually on market days, followed by Bulanan loans with monthly repayments. In urban areas, the Lapanan loan with its 35-day schedule was most popular. Propensities to save are pronounced. In addition to the BKK compulsory savings scheme, 40% of clients indicated that they had additional savings accounts. 83% of these savings are held in informal (arisan 51%, simpan-pinjam 20%) and 17% in formal financial institutions. Given a rural propensity to save of 20% as found in the 1978 Indonesian Household Budget Survey, the potential for domestic funds mobilization is considerable.

Given the fungibility of money, the impact of one discrete source of funds, such as BKK loans, is difficult to estimate. However, the large majority of respondents stated that the BKK loans had positive effects on their business activities: on the volume of materials purchased (82%), the variety of goods sold (37%), the number of customers (75%), sales volume (81%) and, last not least, net profits (92%). Respondents felt they were still far from market saturation. 59% also indicated that BKK loans had an impact on employment: 50% said BKK loans led to additional employment, and 9% said it alleviated underemployment. There is a multiplier effect of BKK loans through backward linkages: through increases in the volume of materials purchased (82%) and in the number of suppliers (36%). Forward linkages have been unimportant; BKK borrowers do not normally serve as intermediate suppliers for other businesses.

BKK has considerably improved community access to credit in rural Central Java. It operates in virtually all sub-districts, and its village posts now (1987) cover about two thirds of the 8,500 villages. Yet, for effective service, each village may eventually require its own BKK post. Despite its broad coverage, the program is capable of satisfying a small proportion of credit needs. Its 400,000 clients (3/1987) represent only 8% of Central Java's 5 million households.

1.4 *Performance*

The BKK program is one of the exceptionally few publicly funded and administered credit programs in the world that are financially viable and even make money from providing loans to small and very small rural enterprises. Interest rates, which are very high compared to institutional finance but low by informal sector standards, can cover their cost of funds, administrative expenses and default losses and allow a substantial build-up of reserves from retained earnings.

While the comprehensive data conceal that a certain, though diminishing, number of BKK units may be operating at very low levels or even have closed, the overall program is on a sound financial footing.

The quality of the BKK portfolio is excellent. Its evaluation presents a complication due to the fact that bad loans are not written off but accumulated year after year and expressed as a percentage of currently outstanding loans. BKK accounting procedures distinguish between bad debts, i.e. loans in arrears for more than 6 months and considered unrecoverable, and arrears in the narrow sense of term, which have been overdue for up to 6 months.

By December 1985, 113,739 loans amounting to Rp. 1.23 bn had been overdue for more then 6 months. These are the bad debts accumulated since 1972 which ought to be written off. Expressed in terms of current outstandings as per 12/1985, they amount to 10.2% of the portfolio. However, when properly expressed in terms of accumulated loans given since 1972, then the proportions would be 1.2% in terms of the total value of loans given and 2.7% in terms of the total number of loans.

Arrears in the narrow sense of the term, i.e. loans overdue for up to 6 months, were 36,897 in number or 8.2% of all loans given during 1985 and Rp. 0.69 bn in value, or 5.8% of loan outstandings per December 1985, or 2.7% of the value of all loans given during that year (taking into consideration a portfolio turnover ratio of 2.2). Excluding bad debts, 8.2% of the lenders were overdue in 1985, owing the program 5.8% of total outstandings, or 2.7% of total loan turnover during that year (*Table 7*).

Table 7
Portfolio performance of 469 BKK per 31/12/1985

	Bad debts*	Arreas**
Number	113.739	36.897
Proportion of total no. of loans in %		
- given since 1972	2.7	.
- given during 1985	.	8.2
Value in bn Rp.	1.23	0.69
Proportion of total value of loans in %		
- given since 1972	1.2	.
- in terms of loan outstandings per 31/12/1982	.	5.8
- in terms of total value of loans given during 1985	.	2.7

* loans overdue for more than 6 months
** loans overdue for up to 6 months

When the program was evaluated in 1982, it was found that portfolio quality varies between urban and rural areas; but social cohesion seems to be the ultimate determining factor. The modern urban centers of Semarang and Tegal, with a more transient population, had the highest default rates in the program, while traditional urban areas, with social cohesion intact, in Pekalongan, Purwokerto and Magelang had the lowest.

It was also found that performance of the BKK program is actually somewhat better than indicated by the above data. For since 1974, the BKK program also serves as a collection agency for some special loan programs run along different principles, which perform poorly compared to BKK. However, performance data cannot easily be separated. The combined balance sheet of the BKK shows that the program is profit-making, self-reliant and essentially self-financing its own expansion. From 1984 to 1986, annual profits have risen from Rp. 1.71 bn to Rp. 2.25 bn, contributing to a gradual built-up of reserves from Rp. 4.58 bn in 1984 to Rp. 8.02 bn in 1986 (*Table 8*).

Table 8
Combined Balance sheet for BKK units, 1984, 1985 and 1986 (per 31/12) in bn Rp.

	1984	1985	1986
Assets			
Cash at hand	0.30	0.35	0.30
Claims on Banks (savings deposits)	0.32	0.32	0.42
Claims on private enterprises and individuals (loans outstandings)	9.42	11.94	15.06
Other assets (materials, buildings, equipment)	0.43	0.65	0.85
Total Assets*	10.47	13.26	16.62
Liabilities			
Bank liabilities (loan from BPD	2.24	2.64	3.64
Village deposits	0.02	0.03	0.05
Deposits of government institutions	0.13	0.20	0.19
Compulsory savings deposits	1.79	2.16	2.48
Profits	1.71	1.98	2.25
Capital and reserves	4.58	6.25	8.02
Total liabilities*	10.74	13.26	16.62

* Discrepancies due to rounding

In their 1982 evaluation, *Goldmark* and *Rosengard* arrived at the conclusion that "*The BKK program is one of the few publicly funded and administered credit programs in the world that makes money from providing loans to small enterprises ... The BKK program has blended the speed and convenience of traditional moneylenders with the operating philosophy and profit margin of a commercial bank.*"

Strengths of the program include

- decentralization of credit delivery and approval authority;
- local autonomy, combined with centralized program supervision;
- broad coverage, reaching down to the village level;
- minimal transaction costs to borrowers by offering direct services in villages on market days;
- simple, easy and fast transaction procedures;
- incentive scheme for staff, linking staff income to BKK profits;
- short maturities;
- quick portfolio turnover;
- character reference for loan eligibility instead of collateral requirements and feasibility studies;
- emphasis on productive loan utilization;
- risk reduction by making small initial loans and by gradually raising credit ceilings on the basis of past repayment performance;
- high recovery rate;
- commercial interest rates, covering all expenses, a risk premium and the cost of funds, including the expansion of the program;
- high profitability;

- high rate of internal fund generation from interest income;
- positive impact on income-generating activities, income and employment.

Weaknesses of the program include

- no systematic penalties on late payments;
- weak savings component;
- low credit ceilings;
- accumulation of bad debts in the books, instead of writing them off;
- ignoring existing self-help groups and their deposit and refinancing needs.

In sum BKK is a publicly funded and administered credit program with a moderate savings component that has achieved the miracle of financial self-sufficiency and profit-making from loans to small rural enterprises.

Table 9
Financial schemes for small enterprises in Indonesia: Summary data on BKK, Central Java

Name	BKK - Baden Kredit Kecamatan
Operating Unit	BPD - Regional Development Bank
Scope	Regional: Central Java
Starting date	1972
No. of loans 1985/86 (millions)	0.53
Outstandings 1986 (millions US $)	9.2
Cumulative realization 1972-86	
no. of loans (millions)	4.83
- amount (millions US $)	84.30
Maturity	2-5 months
Effective interest rate	5.3% - 6.9% p.m.
Recovery rate	97.3%
Liabilities	
- Bank liabilities	3.87
- Savings	2.48
- Profits	2.25
- Capital and reserves	8.02
Total liabilities	16.62

2. Simpedes and Kupedes: Savings and Credit in a Deregulated Financial Market

Summary

The significance of SIMPEDES and KUPEDES lies in their message to large government banks. It shows how they can respond to a change in the policy environment from a regulated to a deregulated financial market.

Until 1983, Bank Rakyat Indonesia (BRI), a government bank with a rural mandate, mainly acted as a development bank, channeling subsidized credit to farmers, small entrepreneurs and cooperatives on behalf of the government. Supported by a general credit guarantee scheme, risk to BRI was minimal, its profit rate almost guaranteed. Since deregulation of the financial system started in 1983, BRI has turned into a universal commercial bank. It has introduced a highly successful savings mobilization scheme, SIMPEDES, and a fast-growing rural credit scheme, KUPEDES, which supplies small farmers and rural micro-entrepreneurs with working capital and investment loans.

Free to set its own terms, BRI has worked out interest rates which cover its costs of funds, transaction costs, a reserve for bad debts and a profit margin.

With repayment rates close to 98 percent and with SIMPEDES growing at an even faster rate than KUPEDES, BRI has virtually reached the point, by December 1989, where its loan portfolio is being financed from its own internal resources.

2.1 *Origin and Delivery Structure*

KUPEDES, Kredit Umum Pedesaan ("general village credit"), is a non-subsidized small credit program for rural enterprises, introduced in 2/1984 and run along commercial lines by Bank Rakyat Indonesia (BRI).

BRI is the largest state commercial bank in Indonesia and the most important formal financial institution in rural areas with national coverage. Its objectives include, in addition to the provision of financial services to the rural population, guidance and supervision of village banks, market banks and other local banks. By 12/1986 it had 297 branch offices, 2,383 village units (unit desa, UDES) on the sub-district level - with an average size of four staff members - and 1,116 temporary village units, thus totaling about 3,500 permanent and temporary village units. Its staff totaled 31,760, 38.8% of them in village units.

BRI village units were established in 1970 to channel agricultural production loans, the so-called BIMAS credit. Between 1970 and 1985, when the program was stopped, with arrears up to 70%, 31,47 million loans had been given, amounting to Rp. 711.51 bn. In addition, BRI also handled 0.81 million KIK/KMKP sugarcane loans from 1974-81, amounting to Rp. 160.64 bn, 3.96 million Mini Credit loans from 1974-83, amounting to Rp. 409.95 bn, and 0.24 million Midi Credit loans from 1980-83, amounting to 96.22 bn. Since 1974, BRI has handled 1.62 million KIK/KMKP loans, amounting to Rp. 2,454.14 bn, which is 56.1% of the total program (per 12/1986). In 1985 and 1986, it lent Rp. 25.16 bn to 961 multipurpose cooperatives (KUD). In the early 1970s, the task of national savings mobilization ("tabanas") was also assigned to the village units - with little initial success, as the balance between program loan and savings interests was negative for the village unit. All these credit programs were - and KIK/KMKP and KUD loans still are - subsidized, with low-interest liquidity credits provided by the central bank. By December 1989, BRI still handled 339 different loan programs as line items on behalf of the Government.

In 1983, bank deregulation provided the basis for BRI to enter into commercial banking in rural areas, by establishing a commercial small enterprise loan program and by intensifying its mobilization of domestic funds.

2.2 *Savings Mobilization*

Under its new policy of commercial banking, BRI is trying to raise its own funds for financing its commercial loans, including KUPEDES. At first, BRI relied largely on central bank liquidity funds, but has been gradually stepping up its domestic resource mobilization. In July 1987, total BRI savings in June 1987 stood at Rp. 2,880 bn, which were also used to finance other programs. Total savings at BRI village units amounted to Rp. 208.6 bn, which is equivalent to 52% of KUPEDES outstandings. BRI village units handle four savings and deposit programs, with 3.86 million savers and depositors (*Table 10*) by July 1987. By September 1989, savings in village units had reached Rp. 748.2 bn, which is equivalent to 98.0% of KUPEDES outstandings - a truly remarkable performance in savings mobilization.

Table 10
Deposits at BRI village units, 6/1987 until 9/1989

Saving Scheme		Clients	Amount in bn Rp.
6/1987:			
Ordinary savings (TABANAS)		3'125.000	66.4
Savings with lottery scheme (SIMPEDES)		707.500	122.1
Fixed deposits		2.300	5.3
Demand deposits		27.000	14.8
Total	6/1987	3'861.800	208.6
	12/1987	.	287.5
	12/1988	.	492.9
	9/1989	.	748.2

The scheme conceived to mobilize personal savings as a major source of finance for the KUPEDES program is SIMPEDES, a savings scheme with the added incentive of two lottery drawings a year, which has proved very attractive. Interest rates for SIMPEDES are 9% p.a. for amounts exceeding Rp. 25,000 up to Rp. 200,000; and 13.5% p.a. for amounts above Rp. 200,000, with interests accruing monthly. In term of volume, it has outstripped the ordinary savings scheme, TABANAS, by far, with rapidly growing numbers. Average savings of the 3.1 million TABANAS clients were only Rp. 21,250 in 1987, while the 0.7 million SIMPEDES clients saved Rp. 172,700 on average.

In 1/1987, SIMPEDES funds matched about 30% of KUPEDES outstandings, with a growing tendency. During the half-year period of January to June, 1987, KUPEDES grew by 17.2%, while the growth rate of SIMPEDES was 34.3%. By September 1989, SIMPEDES funds had reached Rp. 536.7 bn, which is 71.7% of all savings at village units.

2.3 *Credit Delivery*

KUPEDES loans range from Rp. 25,000 to 2 million ($15-$1,200), averaging around Rp. 300,000. There are two types of loans:

- investment loans of a maximum maturity of 3 years at a nominal interest rate of 1% per month (flat, i.e., on the nominal principal, not on the remaining balance) for timely repayment and 1.5% when in arrears.
- working capital loans of a maximum maturity of 2 years at a nominal interest rate of 1.5% per month for timely repayment and 2.0% (= 44% effective rate per annum) when in arrears.

The loan contract provides for an annual interest of 18% (flat!) for investment and of 24% (flat!) for working capital loans, minus a rebate of 6% in case of timely repayment. Taking into account actual timely repayment rates and the distribution of loan types, the overall flat interest rate on KUPEDES loans is 18.1% p.a. As this is a flat rate, the effective rate is approximately 36% p.a.

The KUPEDES scheme has grown rapidly, serving 1.3 million clients with a total amount of outstanding loans of Rp. 403 bn, i.e. Rp. 289,000 ($ 176) on average in 6/1987. By September 1989, KUPEDES outstandings had reached Rp. 763.4 bn.

During the first three-and-a-half years of its existence (2/1984-6/1987), 3.6 million clients had received a total of Rp. 1,294 bn (US$ 788.1 million) in KUPEDES loans, i.e. Rp. 359,000 (US$ 219) per loan (*Table 11*).

Table 11
KUPEDES credit realization, 1984-1989

Year	Outstanding Loans		Arreas	
	No. of clients	Amount in bn Rp.	Amount	Percent
1984	640'746	110.70	0.55	0.15
1985	1034'532	229.03	4.80	2.04
1986	1231'723	334.40	14.97	4.47
6/1987	1301'346	403.16	22.46	5.6
12/1987	.	429.2	.	.
12/1988		538.7	.	.
9/1989	.	763.4	51.6	6.76
Cumulative realization by 1987*	3592'126	1287.00	22.46	1.7

* Cumulative figures are not the sum of year-end outstandings!

Between January and June 1987, the number of Kupedes clients has grown from 1.24 million to 1.30 million, at a rate of more than 10,000 new clients per month. During the same period, the amount of outstandings has grown from Rp. 344.01 bn to Rp. 403.16 bn, at a rate of about 10 bn per month.

A breakdown of figures by type of loan indicates that by far the greatest need of rural small enterprises is for working capital loans: 96.4% of the loan volume of outstanding KUPEDES loans by 6/1987 was for working capital loans and only 3.6% for investment loans. There are some sectoral differences, with higher proportions of investment loans in industry/handicrafts (12%) and a lower proportion in trade (2.1%).

Sectorally, the largest part of the loans went into trade, namely 68.0%, followed by agriculture with 27.6%. Crafts and industry received a negligible share of 2.0% only (*Table 12*).

Table 12
Outstanding KUPEDES loans by type of loan and sector, June 1987 (values in bn Rp.)

Sector	Investment loans		Working capital loans		Total	
	Clients	Amount	Clients	Amount	Clients	Amount
Agriculture	13.853	5.54	364.602	105.94	378.455	111.47
Industry	2.129	0.95	22.550	6.99	24.679	7.94
Trade	15.391	5.65	845.102	268.53	860.493	274.18
Misc.	10.915	2.35	26.804	7.22	37.719	9.57
Total *	42.288	14.49	1'259.058	388.67	1'301.346	403.16

* Discrepancies due to rounding

2.4 *Performance*

KUPEDES is a commercially run credit program which during the first 3.5 years of its existence has reached 3.5 million clients, disbursing Rp. 1,294 bn to small rural enterprises. It caters particularly for their working capital needs. Arrears, which are defined as loans overdue for any period of time, stand at 5.6% of 7/1987 outstandings and 1.7% of cumulative loans. In 9/1989, arreas represented 6.76% of outstandings. As arrears are accumulated in the books and not written off, it is appropriate to express them in terms of cumulative loan amounts, i.e. 1.7%. The long-term loss ratio in 9/1989 was 3.32%, the short-term loss ratio 2.29%.

At the same time, BRI has been very successful in its efforts in mobilizing rural savings to raise its own funds as a source of finance. In 9/1989, savings at village level financed 98% of loans at the same level.

Interest rates charged in KUPEDES are commercial rates, which are considerably higher than the rates charged in special government programs but much lower than those on the informal financial market. They are calculated in such a way that BRI is able to pay for the cost of funds, administrative expenses, a risk premium, and, in addition, make a profit. This has proved a powerful incentive for the expansion of the program. It proves that a commercial credit program for small rural enterprises can be financially viable and at the same time attractive to the borrowers. Access to credit at reasonable transaction costs is more important to small enterprises than the absolute magnitude of interest rates. However, with an average of about 300 SIMPEDES and 550 KUPEDES clients per village unit (7/1987), there is still considerable potential of growth. With growth rates of 34.2% in the case of SIMPEDES and 17.2% of KUPEDES during the first half of 1987, this potential for growth was being successfully tapped: a process which has continued uninterruptedly as the data for 9/1989 show.

2.5 *Impact*

In many rural parts of Indonesia, KUPEDES is the only commercial credit program which is effectively accessible to small enterprises. Together with the savings deposit facilities offered by the BRI village units, it offers an adequate range of financial services to the rural population. In the absence of detailed impact data, it can be assumed that the program contributes to the stabilization and to the gradual growth of small rural enterprises, particularly in the realm of off-farm activities, with positive impacts on income, production and services, and secondary effects on employment.

Strengths of the program include

- run as banking business along regular banking principles;
- commercial interest rates;
- rapid growth;
- financially viable;
- decentralization of credit delivery;
- low transaction costs for borrowers;
- large number of small loans;
- low arrears.

Weaknesses of the program include

- ignoring existing self-help groups and their deposit and refinancing needs;
- insufficient delivery structure at the grass roots level;
- insufficient coverage for the poorer sections of the village population.

In sum, KUPEDES is a financially viable credit program for small rural enterprises but less so for micro-enterprises and small-scale income-generating activities, run along commercial lines, with broad national coverage.

Table 13
Financial schemes for small enterprises in Indonesia
Summary data on KUPEDES (Bank Rakyat Indonesia)

Name	KUPEDES - general rural credit
Operating unit	Bank Rakyat Indonesia
Scope	National: rural small enterprises
Starting date	1984
No. of loans 1986 (millions)	1.2
Outstandings 1986 (millions US$)	204
Outstandings 9/1989 (millions US $	428
Cumulative realization (7/87):	
- no. of loans (millions)	3.6
- amount (millions US$)	784
Maturity	3 years (investment); 2 years (working capital); average 1 year
Effective interest rate	33% p.a.
Recovery rate (long term) (7/1987)	97.8%
Recovery rate (long term) (9/1989)	96.7%
Domestic resource mobilization through village units:	
7/1987	52% of KUPEDES outstandings
12/1987	67% of KUPEDES outstandings
12/1988	91.5% of KUPEDES outstandings
9/1989	98.0% of KUPEDES outstandings

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