REACHING THE HARD TO REACH:

Comparative Study of Member-Owned Financial Institutions in Remote Rural Areas

CASE STUDY

Muntigunung Lembaga Perkreditan Desa, Indonesia:
Village Ownership as a Model for Remote Outreach of Financial Services

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Abbreviations

BKD	Badan Kredit Desa
BKK	Badan Kredit Kecamatan
BPD	Bank Pembangunan Daerah
BPR	Bank Perkreditan Rakyat
BRI	Bank Rakyat Indonesia
LDKP	Lembaga Dana Kredit Pedesaan
LPD	Lembaga Perkreditan Desa
PLPDK	Pembina Lembaga Perkreditan Desa Kabupaten/Kota
NBFC	Non-Banking Financial Companies

Muntigunung Lembaga Perkreditan Desa, Indonesia: Village Ownership as a Model for Remote Outreach of Financial Services[1]

Executive Summary

Lembaga Perkreditan Desas (LPDs), village-based financial institutions in Bali, Indonesia present an interesting model for remote outreach. At first glance, outreach at the institutional level is not high. The case LPD has 1,020 members, all of the residents in the village. Only a fraction of those members make use of financial services.

Nevertheless, this village-based model has the potential to broaden access to rural, remote areas by making use of existing local governance structures. Because the LPD is owned and governed by the customary village council it means that nearly every village on the island has, at least, access to financial services. In Indonesia financial institutions, particularly microfinancial institutions, are highly regional. In 2006, there were over 1328 LPDs in Bali reaching over 90% of households. While this model may seem idiosyncratic to Bali and its culture, local governance structures exist in most villages in some form.

Basing the financial institution in each village has enabled LPDs to achieve broad and remote outreach through lowered costs and local ownership, as well as a high level of acceptance and trust among local people. Part of the profits are, according to policy, reinvested in the community and members participate actively in determining the use of surplus. Since LPDs are owned by the traditional council, and managed, in part, with traditional laws, member accountability to the MOI is high which makes for strong control of credit risks. Social costs of non-payment are very high including excommunication.

Building on local governance structures and the corresponding socio-cultural power structures has its challenges too. While this model is very effective for credit risk, there is not an effective mechanism to hold the customary council accountable. While the majority of LPDs are rated 'sound'[2], their decentralized nature and lack of sufficient oversight and internal capacity leaves them at risk of mismanagement and fraud when village members are reluctant to challenge traditional authority figures. In other words, the risk of elite domination, prevalent in rural areas, can be more pronounced in this context where the local leadership is responsible for governance. The existing system of self-regulation through the provincial government is not effective or consistently applied in rural areas.

The supervisory design builds in a percentage that needs to be dedicated to cover supervision costs. Even though this percentage is not currently enough, the principle is sound. There are capacity issues as well since the rating system (CAMEL) is complex and ill suited to smaller LPDs in rural

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[1] This study would not have been possible without the support of the staff of Bank Pembangunan Daerah (BPD) Denpasar, the GTZ-PROFI team both in Jakarta and Denpasar especially Mr. M. Hamp and Mr Nurcahya. LPD Muntigunung's staff played a key role in helping us collect and assimilate data in the field and extended their full cooperation in all our work. I also acknowledge the help of Mr. Burhan Suriwinata who not only helped translate critical document and field discussions but also with his extensive experience in the banking sector, provided tremendous support in understanding the financial sector in Indonesia.

[2] Rated using a modified CAMEL tool by BPD and PLPDK. For details see section on supervision.

areas. Rural LPDs also require greater options for external recapitalization and liquidity exchange to effectively meet village demand for financial service.

The experience of LPDs also suggests that local ownership does not necessarily ensure depth of outreach or flexible services. Even though all residents have access only about one-fifth at any time are actually making use of financial services. Strict collateral requirements and other rigidities limit broader outreach. Because the representation in the LPD is family-based and the household head is male, women typically use financial services less and participate less actively in both governance and management.

The LPD system has many innovative elements—a supervisory design that allows for cost recovery, an incentive structure for staff tied to performance, community ownership and the use of local customary laws for credit control. However, the LPD case also highlights the risks of MOIs being too locally oriented, especially regarding internal governance, without effective external regulation and supervision to counterbalance the influence of traditional power structures.

Context and Case Selection

The Microfinance Sector in Indonesia

Financial access for the rural sector and, in particular, the rural poor is still limited in Indonesia. Despite efforts by central and provincial governments to extend microfinance to rural areas, and the success story of Bank Rakyat Indonesia (BRI), a BRI survey shows two thirds of village households lack access to formal or semi-formal financial services. Among households with no viable enterprise, 62% had no savings account, and 68% had no credit from any financial institution, while 52% of households with viable enterprises had no loan from a financial institution (BRI, 2001 in Jansen, Hamp, & Hannig, 2005).

This persistent gap in access stands in stark contrast to the highly diversified network of rural (especially micro) finance institutions in Indonesia. Indonesia's history of foreign influence, financial crises and government initiatives has led to a complex, at times confusing web of financial institutions led largely by various government levels. Institutional microfinance in Indonesia comprises: Commercial banks, the most prominent is the public bank *Bank Rakyat Indonesia* (BRI) and its pervasive Unit *Desa* system; people's credit banks called *Bank Perkreditan Rakyat* (BPR), subject to the banking act and regulated by Bank Indonesia; and non-bank financial institutions called *Lembaga Dana Kredit Pedesaan* (LDKP) regulated by the Ministry of Home Affairs and provincial governments. Indonesia also has cooperatives subject to cooperative law, pawnshops regulated by the Ministry of Finance, unregulated local organizations such as savings and credit associations, and village administration owned institutions called *Badan Kredit Desa* (BKD) which do not seem to come under any form of regulation (Holloh, 2001). Other microfinance programs offer subsidized funds in the form of microcredit to targeted groups such as the poor, small farmers, entrepreneurs and NGOs. However institutional finance has not succeeded in reaching down to the village. Microfinance institutions such as BRl units, BPR, BKD, LDKP and cooperatives operating at the sub-district level tend to have only a limited reach to rural villages and low-income groups.

The first LPDs were established in 1985. Their current form and regulatory and supervisory framework was formalised by a decree issued in 2002 by the Bali Provincial Government. As per the decree 'LPD' refers to a village-owned financial business entity and any village can have one LPD. A village is in fact, a traditional law community unit called *Desa Pakraman* or *Desa Adat*. The LPD receives its legitimacy from the *awig awig* or 'written traditional law' of such a *Desa Adat* (Bali Province Regulation No. 8 of 2002). This is in contrast to other village level savings and loan associations in Indonesia which are largely owned and managed by administrative bodies rather than communities bound together by customary law. The Pembina Lembaga Perkreditan Desa Kabupaten/Kota (PLPDK) is responsible to provide technical guidance, institutional building and training support for LPDs. An LPD through special permission from Bank Indonesia (vide letter dated 17 February 1999) is allowed to mobilize savings from members of *Desa Adat*. The LPD is allowed to issue loans only to members of their traditional *Desa Adat*, but can receive loans from any financial institution.

The three kinds of institutions which have played a major role in meeting rural financial needs in Indonesia are: the BRI Units, the BPR (generally the form to which microfinance organizations transform), and the LDKPs, a diverse and largely unsupervised set of institutions, which include LPDs. In addition a fourth kind of credit institution, *Pegadaian* (or pawnshops) is a source of largely short term liquidity, in both rural and urban areas. Pawnshops are a government monopoly—as of 2002 the system had 760 pawnshops with 6,600 employees.

Figure 1: The Microfinance Sector in Indonesia and its Key Institutional Participants

	Institution	Unit	Creditor	Credit	Savers	Saving
1	BPR	2,148	2,400,000	Rs9,431,000,000,000	5,610,000	Rs9,254,000,000,000
2	BRI Unit	3,916	3,100,000	Rs14,182,000,000,000	29,870,000	Rs27,429,000,000,000
3	BKD	5,345	400,000	Rs197,000,000	480,000	Rs380,000,000
4	KSP	1,097	665,000	Rs531,000,000,000	n/a	Rs85,000,000,000
5	USP	35,218	Na	Rs3,629,000,000,000	n/a	Rs1,157,000,000,000
6	LDKP	2,272	1,300,000	Rs358,000,000,000	n/a	Rs334,000,000,000
7	Pegadaian	264	16,867	Rs157,697,252,000	No Savers	No Savings
8	BMT	3,038	1,200,000	Rs157,000,000,000	n/a	Rs209,000,000,000
9	Credit Union	1,146	397,401	Rs505,729,317,823	293,648	Rs188,014,828,884
TOTAL		54,444	9,479,268	Rs28,951,623,569,823	36,253,648	Rs38,656,394,828,884

Data compiled by Gema PKM, October 2004

BRI's microfinance window, despite being the largest microfinance provider has not really managed to extend services to remote areas. Most of the units are located in or in close vicinity of urban areas and most units simply lack the human resources to expand their business to the village level (Holloh, 2001). These restrictions are also reflected by the units' loan sizes, which are usually larger than US$100 and relatively high for rural areas. Similarly only around 50% of the BPRs are rural and for the better performing BPR, the competition is mostly commercial bank branches rather than small decentralised service providers at the village level.

Figure 2: District and Sub District Level Distribution of Institutions

National Level		
Institution	**Number**	**Status**
BRI	> 4000 branches	Regulated bank
BPR	>2000 units (secondary unit banks)	
LDKP (incl. LPD)	> 1500 institutions	Largely regulated by provincial and district governments, selectively allowed to raise deposits
Cooperatives	> 35000	Include credit unions, savings and loan cooperatives and savings and loan units of multipurpose cooperatives, supervision and guidance by local provincial governments
Regional Level		
LPD (Bali)	LPD, > 1300	Regulated by Provincial Governments, allowed to collect savings and time deposits
BKD (Java)	> 4500	Regulatory status not clear although recognised by some as BPRs

LDKPs exist mostly in Java and Bali and aside from LPD, are owned by provincial and district governments. LPDs made up nearly 60% of total LDKP units in 2004 (Jansen, Hamp, & Hannig, 2004). The only other significant institutions at the village level are BKDs which depend on decisions of the village administration, lack effective internal control, and a sense of ownership and trust among the village population (Holloh, 2001). BKDs were earlier recognized as BPR, but there is now some ambiguity around whether they are in fact regulated (Holloh, 2001). A 1992 Banking Act required all BKD and LPKDs to convert to BPRs however no BKD and only 30% LDKPs (Nurcahya, 2005) did so. BKDs, one of the oldest forms of institutions (established by the Dutch colonial government as far back as 1905) have not grown in number for many years.

In contrast to these village level institutions, LPDs are better financial performers, have broader and deeper outreach, and a strong degree of community ownership. Holloh (2001) emphasises that LPDs in terms of deposit mobilisation, asset quality and sustainability are by far the more successful of LDKPs. In terms of market penetration LPD's membership covers well over 90% of the population of Indonesia's major island of Bali. Their number (1,296 in the year 2004) increased to 1,328 as of April 2006 (BPD Denpasar, Indonesia).

Local Context and Selection Methodology

The intention of the research was to investigate the potential MOIs have to examine depth, breadth, scope, length, worth and cost of remote outreach. The second level of analysis examined how outreach was affected by three areas: Networking and linkages; governance and ownership; and regulation and supervision. The perspective of analysis was from the lowest tier association.

Selection of the case LPD was done on the basis of three criteria: The MOI's remoteness, strong performance (based on CAMEL ratings and discussions with PLPDK), and relative breadth of outreach (expressed in the case of LPD as a proportion of market also at the regency level). Based on the above we selected Muntigunung LPD in Tulambein village, Karengassem Regency, Bali. LPDs originated and proliferated most on this island and not only serve the more affluent southern regencies, but also the poor and physically remote, hilly northern and northeastern regions.

Two weeks of field research were conducted with the Muntigunung LPD. Outreach was measured in terms of Schreiner's (1998) six aspects: Breadth, depth, cost, worth, length, scope. Financial and outreach data covering Muntigunung LPD contrasted with regency averages using researcher assessment against BPD-generated CAMEL-based audit reports. Wealth ranking was done in one settlement (Muntigunung) with LPD borrowers. Four focus groups were held with members according to the following: a) two with a mix of livelihoods; b) one with only women borrowers (family members joined in); c) one with only extremely poor borrowers. These focus group discussions and mapping exercises, particularly worth/demand of alternative financial services and ownership, included a cross section of general LPD members (ensuring some representation of current borrowers). Key informant interviews were held with key LPD staff and regulators.

MOI Outreach Performance

Breadth and Depth of Outreach

As noted above, LPDs have broad household coverage in Bali. Using the indicator of average loan size LPDs also show far greater depth of outreach than other rural financial institutions like BRI and Bank Pembangunan Daerah (BPD).

Figure 3: Depth of Outreach of Key Rural Financial Institutions in Indonesia (US$)

Institutions	Outlets	No. of Outstanding Loans	Loan Amount	Loan per account	No. of Savings Accounts	Savings	Savings per account
BPR	2156	2,400,000	1,041,800,000	434	5,610,000	925,400,000	165
BRI Units	4049	3,100,000	1,418,200,000	457	29,870,000	2,742,900,000	92
*LPD**	1296	317,293	96,645,844	305	911,272	60,350,350	66

(Jansen, Hamp & Hannig, 2004).

Figures for LPD relate to clients not accounts, for both savings and loans which implies an even greater depth of outreach for LPDs (one client may have more than one savings or loan account) than is indicated by Figure 3. Even using the client figures, LPDs show far greater depth of outreach than both BPRs and BRI. Figures relate to the whole of Indonesia except for LPDs which are found only in Bali, thus they do not really provide a comparative picture of the market penetration of the LPDs and other institutions, but provide only a sense of the relative depth of outreach.

Karangasem regency (2003 pop. 388,320) in the north-east, is the poorest and most remote area in Bali. The 156 LPDs in Karangasem regency have savings per capita of US$17.90 as against the average for all LPDs in Bali which is approximately US$33.50. LPDs in Karangasem have a combined outreach of 52,461 savers and 27,753 borrowers (13.5% and 7.1% of the estimated population) which is below the average for the system due to a thin dispersion of population and relative poverty of the region which makes it difficult for people to save.

The Muntigunung LPD reaches out to 1,020 members (all households in the *Desa Adat*). There are 249 borrowers, approximately 24% of the village population. Muntigunung is the most remote, poorest settlement in Karangasem regency according to local PLPDK officials. The average savings per capita for this LPD is US$11, well below the average of even Karangasem regency. Muntigunung's poverty is exacerbated by its location on hilly terrain which makes irrigation and the availability of drinking water extremely difficult. Drinking water is transported manually in containers up the hills during the dry season. In addition, due to distance from the regency headquarters, this area does not attract enough tourism to allow for diversification away from agriculture.

While all members can in theory access savings and credit services there is a limit to universal access especially to loans. This is a result of the requirement for collateral, as clearly detailed in the *awig awig* or local customary law of Muntigunung, which requires loans to be collateralized, and lays out strict punishment if the member defaults—all measures aimed at managing the risk on non-repayment of loans. Collateral required is always to the full value of the loan and may include anything from land titles to motorcycles, etc. This may also be the reason why access for women to LPD services is low as most do not possess land titles and other assets in their own names. Where women were widows or for some other reason had access to land titles, they were able to get loans. Of the total number of borrowers (173) only 21 women had accessed loans.

A cap on loan size (US$22) is effectively a way of 'targeting out' the rich who may require larger loan sizes. A wealth ranking exercise with LPD members indicated that there were only two rich households among current borrowers–the maximum participants being the poor. However there was also relatively little participation of the ultra poor (five borrowers). Poverty ranking was done with a cross section of general LPD members (ensuring some representation of current borrowers).

Scope, Worth and Cost of Outreach

The sense of worth of LPDs services is strong in the village community, so much so that a recently concluded customer satisfaction survey of BPRs and LPDs observed, "LPD customers show a strong loyalty bias toward the LPDs, even though their underlying satisfaction with the LPD service and products is less than that of BPR customers" (Johnson, 2006). Satisfaction was gauged on a number of levels: Products and services, office infrastructure, staff attitude, etc. Specifically in the case of product satisfaction, LPD borrowers seem relatively more satisfied with their institution's product offerings than do BPR borrowers, particularly with respect to the interest rate.

Focus group discussions with LPD Muntigunung's members echoed findings of the customer satisfaction survey, as also the national data on lack of access to BRI and other rural financial institutions (see 'background'). They also highlight why members preferred the LPD's services and perceived them in sum to be cheaper.

The LPDs' products include two loan and two deposit (savings and time) products. The more popular loan product has a term ranging from 1 month to 20 months (interest rate charged on a declining basis ranges from 3% to 3.5% per month depending on the term) with a flexible repayment schedule. A less popular product is a fixed monthly installment product which charges a flat rate (interest rate ranging from 2% to 2.5% per month depending on term). Additional charges include 3% compulsory savings and 3% loan fees. 88% of the loans were given for productive use however some loans were also given for consumption, largely the purchase of motorcycles.

Members emphasized that they could not access BRI due to complicated loan application procedures and distance of local BRI branches. (Interestingly enough, LPD staff preferred BRI to BPD as a refinancier due to the proximity of the BRI outpost compared to BPD. At every level, geographical proximity was a key determinant in choice of service provider.) The satisfaction survey which looked at a sample of ten large and small LPDs also found that LPD customer service satisfaction is highest with respect to accessibility.

Figure 4: Comparative Chart of Financial Service Providers from Member Perspective

Provider	Loan Product	Savings	Accessibility as reported by members	Other
LPD	Term loans: one fixed, one with flexible repayment schedule. No minimum amount Fixed charges 24 -30% yr. (nominal interest rate) Flexible: 36-42% yr. depending on term (nominal interest rate) Both require 3% compulsory saving and 3% loan fees. (All declining balance)	Compulsory deposit – 3% of loan Time deposits – 3, 6, 12, 24 and 36 mo. 10.8% yr. Min. opening balance US$ 45. Fixed deposit: 3-11 mo. – 10.8% yr. 12-19 mo. – 12% yr. 20-35 mo. - 15 yr. 36 mo > 18% yr. Savings accounts minimum opening balance of US$0.45 7.2% yr. (no lock in period).	Highly accessible physically. Even if office is closed they can save or withdraw by meeting the LPD manager. Affordable by all.	Loans are collateralized, simple application procedures. No customers for fixed installment loans
Money-lender	Loans of no fixed tenure charge 120% yr. (nominal)		In village but poorest cannot afford	Collateralised simple application procedures
BRI	Agriculture loans 24% yr. (Flat), 2 year term	(Members not aware of savings products although BRI offers a range of competitive savings products)	Nearest branch 8-20 km from village. Officers do not visit village. Hours inconvenient. Staff not known personally.	Collateralised complicated application procedures

Members preferred to save with the local LPD over other institutions. LPD clients felt placing their savings with the LPD would mean they had ready access to their money. Users also trust LPDs as a safe place to save. The fact that the LPD management and staff is local and the manager is a respected school teacher in the same *Desa Adat* has much to do with the general trust bestowed on the local LPD by its members.

Customers were more than satisfied with the small local management team of the LPD and communication was not considered a problem. Members expressed that they may still go to other institutions to borrow if significantly better interest rates were offered or branches were opened in closer areas. Most importantly they felt the profits of the LPD would ultimately come back to their village and help in developing their village.

Suitability of products to household cash flows is a greater determinant than the rate of interest in choosing a service provider. Women's savings groups (established under various government programs) in the village had not proliferated as they were unsuitable for poorer households due to the need for regular savings. Local moneylenders charge 120% per annum, much more than the LPD, however the key issue was the requirement of monthly payment of the moneylender which does not suit the seasonality of predominantly agricultural livelihoods in the area. In fact, a similar product introduced by the LPD (fixed monthly installments) has found no takers.

Box 1: Discussions with LPD Members

Nyoman Keneh is an extremely poor client of the LPD who cannot afford loans from the moneylender. She once took a loan from a shop to fix her house and had a very difficult time trying to pay it back. Her husband sells ice cream, however, sales are low during the rainy season (unlike the dry season) when he is forced to become a garbage collector to make ends meet. During that time they have no savings and no way to repay loans. She is not a member of women's groups because she cannot save regularly. Her husband fell ill and had to be taken to Singharaja. She immediately received a US$200 loan from the LPD. She can decide when to pay her principal and her interest payments are regular. She feels the LPD is there for her during her time of need and due to their flexibility, she does not feel pressured to pay them money even during the rainy season.

Made Sumi is a farmer and plants maize and cassava. He has a wife and four children. He does not want his children to become farmers as it is a difficult life. Since June 2006, he has been saving for their higher education with the LPD. The LPD gives him the option of making a fixed deposit so he is not tempted to withdraw. He feels the banks are too far away and he wants to keep track of how much money is accumulating in his account. He can do that with the LPD since it is in the village. His impression of the LPD is that its funds are growing and soon it will generate more profit and possibly be able to give better interest rates on savings as well.

Overall the LPD was valued for its accessibility, the fit of its products to household cash flows, the local staffing and management. In this remote area, where experiences with fly-by-night operators abound with members being cheated out of sums of money, the sense of control and familiarity that a local institution offers is key to determining choice. Despite the LPD's high interest rate and other issues (see following sections) it remains a popular choice to access loans for productive purposes.

Combined with strong internal controls and credit risk management of the organization (see sections on governance, regulation and supervision), the high level trust of members creates the potential for sustainable and broad outreach. However controls such as managing credit risk, place effective limits on depth of outreach. Unlike other group based microfinance methods, LPDs do not seem to have replaced economic with social collateral or even savings (only 88 members are saving in time deposits and savings products). This has not only limited access of the ultra poor but also of women. The LPD therefore seems to be walking a tight rope between managing risk and achieving real depth of outreach which would be dependent to a very extent on strengthening the actual savings orientation and social collateral of the LPD.

Length of Outreach

As per the modified CAMEL rating conducted by PLPDK and BPD Bali the LPD industry as a whole is performing well with nearly 75% of the LPDs being sound.

Figure 5: Rating of Bali LPDs

Classification	December 2004		December 2005	
	LPD	%	LPD	%
Sound	925	71	974	75
Fairly Sound	190	15	101	8
Less sound	61	5	91	7
Unsound	120	9	138	10
	1296	100	1304	100

Source: Nurcahya, 2005

The Muntigunung LPD was rated sound by BPD using modified CAMEL standards. These standards appraise capital adequacy, asset quality, management quality, liquidity and profitability. Based on assessment of the five factors, the LPD soundness is determined, as 'sound', 'fairly sound', 'less sound' or 'unsound'. According to our own analysis the Muntigunung LPD has reached an Operating Self Sufficiency of 200% (unadjusted for market cost of capital and inflation), and a Financial Self Sufficiency of 190%. In terms of profitability, return on assets of 18% is largely due to the relatively high interest rates charged on loans (ranging 24-36% nominal, declining balance). The low operating expense ratio of 4.14% shows that the LPD like other member owned institutions takes advantage of a low operating cost to reach deep and far into remote areas.

Box 2: Proceedings of the LPD 35 day meeting (See also the section on governance)

All family heads are present for the meeting. The LPD manager formally reads out the financial statement of the LPD. He notes that there are some people absent as it is the cloves season and people have gone to Singharaja to sell their produce. He reads out names of people who are late in their repayments and asks them to be informed that they must pay on time. These borrowers are going to be penalized and if they will not pay, their mandatory savings accounts will be deducted.

One member asks why another member who wanted to construct a house was refused a loan. The LPD manager says there were no funds available for lending. The members asked is that because people are not repaying. The manager responds that repayments are largely delayed only at the beginning of the rainy season. The lack of funds is because one customer with large saving withdrew his money. Money is also not yet available from BPD as a result there are not adequate funds to provide a loan especially for construction—which requires a larger loan.

The member is not convinced. He asks how many people have saved in the LPD and why is it that one person's withdrawing the savings should result in lack of funds? What is LPD staff doing to attract more savers? The manager says he goes from house to house to tell people about savings but people are poor and they want to repay loans first so savings are not large enough to cover the need for loans yet. The LPD Supervisor then deferred the remaining discussion to the next meeting.

Later that same day when we asked the manager about why that question was being raised in the meeting he replied that it was raised in every meeting because people want more loans and larger loans. I have to manage either by giving them loans of a smaller amount or telling them to come to me after one month or two months.

However significant limits exist to the future growth of LPDs. Discussions with the Muntigunung management indicate that the demand for loans already far outstrips the ability of the LPD to service them. (For a more detailed discussion of this issue see the section on linkages).

The kind of small LPD that Muntigunung has, even though it is rated sound, typically will not have access to BPD funds until having finished at least three years of operations. When these funds are made available they will not cover the full demand that the LPD has. In the past one significant issue has been that the BPD requires collateral for refinance—which in some cases was provided through personal funds of the LPD manager. Now there is a recommendation that for loans less than US$5,000 the need for collateral be waived and that insurance guarantee be extended to such loans. There is no regulatory constraint on raising funds from sources other than the BPD however in practice this is difficult. BRI charges an interest rate on refinance (2% per month) which will not leave the LPD with requisite margins. It is not easy to negotiate a loan from other LPDs as the traditional/legal guidelines for this are not clear. It is possible that liquidity shortfalls and excesses could be transferred within the LPD industry. Unfortunately, this demands efficient linkages between them and one (or more) effective input suppliers.

What Has Enabled This Member-Owned Institution to Achieve Remote Outreach?

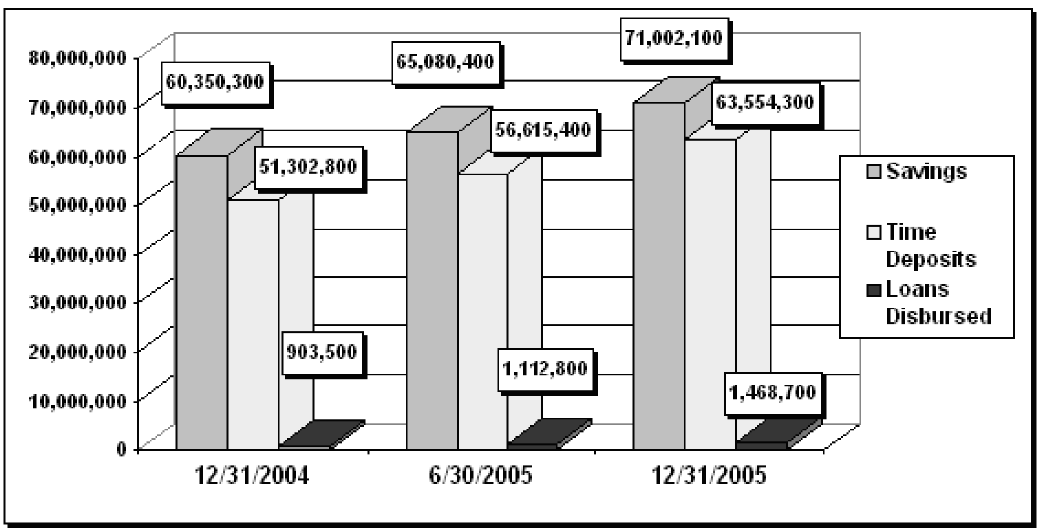
Linkages by Design Do Not Address Diversity

"LPDs are everywhere in Bali," according to a local BPD official. LPDs are geographically the closest service post for the last and poorest customer wanting to access financial services. LPDs like many other MOIs serve diverse regions, ranging from urban populations like Denpasar where LPD offices have large staff and look like branches of commercial banks, to small settlements like Muntigunung where one small room donated by a local charity serves as the office for three staff.

The LPD industry itself is fairly diverse in terms of size of assets—with a range from LPDs which have assets greater than US$500,000 to those with assets of approximately US$20,000. These diverse LPDs have different liquidity and training requirements—the source of both which are currently largely the BPD and the PLPDKs.

LPDs fitting in the former category are less than 10% even though as a whole the industry is growing. Figure 6 shows that the LPD system as a whole appears to be overliquid. For those 90% of LPDs which are in the latter category liquidity, however, remains a major problem.

Figure 6: Savings and Loan Portfolios for LPD System (US$)



Currently larger LPDs place excess liquidity with BPD. Historically interbank assets showed growth of cash and liquidity deposited in the BPD, particularly between 1996 and 1999 with an average annual growth rate of 84%. More than 90% of the liquidity was placed in the BPD (Holloh, 2000). Currently interbank assets are close to 20% of overall assets, whereas at the end of 1999, this liquidity made up 35% of total assets. This is still significant in terms of the potential to service LPDs like Muntigunung. The high level of deposits with BPD seemed to indicate that the system was overliquid. In fact, this was limited to only a few larger LPDs. Figures reported by BPD Bali staff show that for smaller LPDs, liquidity shortages are the problem. For nearly 90% of 'CEHAT' rated or well-performing LPDs (974 LPDs of 1,304) are looking for different sources of finance. Loan to deposit ratios for the sector as a whole (system average for 2006 as stated by BPD Bali) are 85-90%, well above the optimal 60%. Due to capital adequacy concerns BPD also actively discourages deposit taking which exacerbates liquidity issues.

Muntigunung's LPD staff state that due to LPD's location, they rarely access training. Their main opportunity for upgrading their understanding is through interactions with PLPDK staff who visits them as a part of their participation in the supervisory committee (see section on regulation and supervision). Staff also said that no one asked them what training was most important. The focus they say is on credit risk management, whereas they need help to understand how to get more deposits, or link with other banks for on-lending funds, or deal with governance issues.

Currently LPD capacity building is evolving in collaboration with Certif, a standard-setting body which certifies BPR Directors, and has strong roots in the commercial banking sector. The agenda is based on a tool such as CAMEL (see section on regulation and supervision) which has long been used largely by commercial banks. How effective this combination will be in relation to a small village based savings and loan association is difficult to say. Certainly the LPD staff's demands for capacity building encompasses a number of areas which have typically needed a distinctive treatment in the case of microfinance institutions from what is given to even small banks. According to the management team the key areas they need support in are building savings discipline, product development, governance, linkages with external agencies, liquidity management, business planning, risk management and management of information systems. The Certif LPD syllabus covers a range of topics on human resources and financial management, planning, and internal and external controls.

In designing linkages, specifically the availability of both refinance and technical services, MOIs are often treated as a homogeneous group whereas due to their local roots they may serve a fairly diverse clientele with different saving and repayment capacities. Given this context, is there an urgent need to re-orient linkages with agencies (such as BPD and PLPDK) to meet different needs?

Local Ownership and Customary Governance: Benefits and Drawbacks

Box 3: Group discussion with LPD borrowers—two sisters, their husbands, and a family

By saving with and borrowing from the LPD we do good for our community. It is our institution. We know all the people—their good and bad points. The profits come back to us. Right now the profits are not large, they stay in the LPD. When they are big enough we will decide together whether to claim them for ourselves or do something good for the village. The law of the LPD is strict—it is written in our own (community law) that no one can default on an LPD loan, or they will be sent away from the village, they cannot be buried in the village of their birth. For any Balinese that is the worst thing that can happen because we are very close to our family. We know from the annual meeting who is late for repayment. Until now there has been no one who has not ultimately repaid the loan. They may be late, they may borrow from some other source but they repay the loan.

Much of the LPD's success is attributed to the balance between a) local ownership and management, b) provincial and customary regulation, and c) external supervision and internal governance. The internal ownership and governance structure of the LPD is decided by the Provincial Decree of 2002 but its foundations are laid in age old Balinese customary law—the *awig awig*. This structure determines the balance between consistency and individuality across the LPD sector. The local customary law has a complex hold on community life. Geertz (1980) calls Bali a "theatre state," governed by rituals and symbols rather than by force. Once passed orally from generation to generation, the *awig awig* is now in written form, and when interlaced with the religious and ceremonial elements of society, comprises a formidable code, diversion from which has serious consequences such as banishment from the village, denied a funeral in the place of birth, etc. Where social bonds and adherence to customary law was weak, LPDs in general performed poorly (Holloh, 2001).

The LPD is owned by a MOI—the *Desa Adat* (or village community), which has claim to a percentage of profits. Profits can be distributed to individuals if so decided by the *adat* or can be used as a lump sum for village development or religious activities. Members of the Muntigunung LPD have decided that since profits of the LPD are currently low, they will be repatriated to the LPDs capital rather than claimed for any other purpose. The *Desa Adat* council *Paruman* is an elected representative body while its general assembly *Parjuman* (comprising the entire population of *Desa Adat*) is the highest decision making agency of the village. The organization of the *Desa Adat* is lineage based in Muntigunung—with 21 families electing their own representatives to the council. We found that the council meetings (held every 35 days) were largely unattended by women, however an annual religious meeting was attended by all people in the village and is the main general assembly where decisions are taken to all members.

While attending the 35-day meeting researchers found that it is highly ritualized reflecting the social and religious order of the village. Its broad agenda—review of LPD progress, announcement of the names of borrowers late with repayments, loan sanctions—is laid out in the *awig awig*. Elected representatives actively question LPD staff and its supervisory committee about issues and the LPD manager attempts to clarify these to the best extent possible. The management committee of the LPD comprising a head, administration staff and cashier, is also selected by the members of the village community. Risk management is again outlined by the *awig awig*. Whether this is practiced is difficult to say, however repayment rates in the Muntigunung LPD are 100%.

"While not all aspects of the LPD experience, particularly Balinese attitudes toward debt and the cohesiveness of the *Desa Adat*, can be replicated elsewhere in Indonesia, the "win-win" institutional relationships developed in Bali could serve as a model for any province"(Patten, Rosengard, Johnston, & Koesoemo, 2003). While the customary laws used are highly contextual and particular to the Balinese context, the transferability is in the balance between social-informal and formal-institutional. Social bonds and customary links help manage credit risk and ensure ownership of the village community, and the external institutional support provides guidance, technical services, some liquidity and an enabling environment.

However what is the right balance and who are the ultimate authorities when something happens to upset it? The remote LPD in Muntigunung helps highlight the widening rift between customary internal and institutional external controls over the LPD. It shows how customary internal controls emphasize credit risk management but do not prepare the LPD to meet broader institutional risks.

Started in 1996, the LPD was shut down for a brief period after its capital was reported as 'wiped out.' It only revived in December 2004 when the Provincial Government capitalized it with US$250. Audited financial statements were not available prior to December 2005. The then manager of the LPD is now the head of the *Desa Adat*. Although it is the official supervisory agency, BPD and the current LPD management have not been able to convince him to furnish details of past dealings of the LPD. So even if BPD does find some anomalies, it really has no way to address the same as only the *Desa Adat* general assembly can take steps to do so. The customary village head over-rode the interest of the LPD despite all efforts of the LPD management and BPD.

Two weaknesses contributed to this situation. The first relates to the supervisory committee of the LPD which is akin to a board in the LPD. Internal control is the responsibility of elected members (non–management and usually a team of three), typically headed by the customary village head (or *Bendesa Adat*). In the case of Muntigunung the *Bendesa Adat* simply does not attend LPD council meetings and the traditional power relations amongst the 21 lineage heads means that not all are equally vocal in demanding answers from him. Ideally each board member should be able to assess the financial condition and operational quality of the organisation. This was not observed in the case of more than one member of the supervisory committee. Also since there was a lack of any proper process of business planning and financial planning it is doubtful whether the supervisory committee had the basic tools that they would need to assess the performance of the LPD. The function of governance of the LPD in some matters was not clearly distinguishable from the functions of management. For example the committee should have fiduciary responsibility to members of the organization. However it seems that management is directly held responsible with Board playing more of a facilitative role.

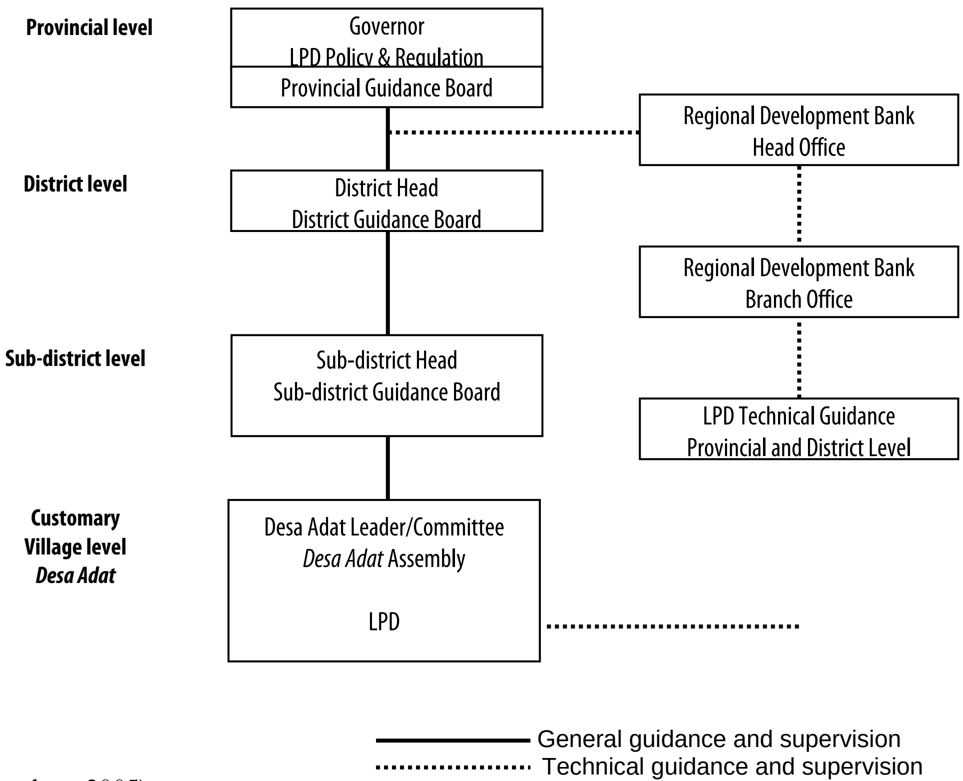
Second, the general assembly's focus, as that of every process relating to governance, is on ensuring repayments rather than on joint decision making on broader institutional issues. LPD staff report that accounts prior to 2004 were demanded from the previous LPD manager (and everyone knew who that person was) in the general assembly. However, discussions with the community reflect that the general assembly or *Desa Adat* was not informed in entirety about issues which seem to incriminate the very same person who is currently their ceremonial and customary head. In the process an opportunity was lost to hold the said person accountable.

In MOIs, especially ones that are remote in location and on the fringes of supervisory oversight, the right balance may in fact be one where the influence of local traditional power structures is limited by strengthening the line of authority and accountability to the general body, the ultimate decision maker, via the board. Member education is critical here otherwise the community will not understand the risks that traditional elite domination can pose, or their own role in mitigating risk. Training can play a key role in building board capacity to foster transparency and to understand the link between governance and institutional performance. The vantage point cannot only be credit risk which is the only area where customary relations have been the most useful. How can external supervision and regulation best complement and address internal governance?

Regulation and Supervision

LPDs are subject to two kinds of supervision—internal and external. External supervision of the LPD is the responsibility of the Governor and implemented jointly by the principal refinance agency for LPDs such as the BPD. The supervisory committee supports internal supervision of the LPD. The members of the committee regularly attend meetings of the LPD and facilitate proceedings of the meetings. LPDs also receive regular on-site supervision from sub-district PLPDK centres and less regularly from BPD. 'Guidance Boards' made up of representatives from provincial, district and sub-district government design and implement policies and provide support to the LPDs.

Figure 7: Regulation and Supervision Designed into LPD Model



(Nurcahya, 2005)

Due to the provincial decree, the LPD is mandated to set aside a percentage of its profits to cover guidance and training costs which also makes it unique as a model. The village community owns the LPD and its profits but the provincial decree specifies how the profit is to be allocated. 5% of profits are to be spent on supervision according to the following schedule:

Capital Reserves – 60%
Village Development Fund – 20%
Production Services – 10%
Funds for Guidance, Supervision and Protection – 5%
Social fund – 5%

The source of funds for external supervision is from the contribution of 5% of net profit of LPD. This is an element of innovation in the system as it aims to meet its own supervisory costs. However as of now the major part of this sum is retained in the provincial government's account in BPD Bali and only 10% actually goes to BPD to meet in part its costs of supervision[3]. As reported by BPD Bali the actual profits collected from the LPDs have so far not been enough to cover even the salaries of field personnel. Despite the presence of incentives to supervise (because BPD is also refinancier) the paucity of staff for the village level in BPD has meant greater reliance on PLPDK

[3] With regards to external supervision the Provincial Government transferred its supervisory role to BPD Bali in 2003, as it recognized the need for strict financial supervision. As the main supervisory body (although not the only supervisory body) BPD has the responsibility to report implementation of its tasks, as referred to in the first dictum to the Governor of Bali. However the general and administrative supervision and guidance is carried out by the Local Government (including the Governor of Bali, and the Head of Regency in Bali).

for a number of sub-functions, including also recommendations of LPD for loans. In sum while the supervisory system has developed into a fairly complex one with multiple stakeholders, no single agency has the best combination of resources, location, skills and interest to put it into effect.

Reporting subsequently is equally complex as many different stakeholders need to be reported to. While PLPDK has the responsibility to compile monthly reports and financial statements and examine these reports in practice, it is the LPD management which ends up spending a significant amount of time compiling quarterly, half yearly and annual reports for different supervisory agencies. Standard reports include qualitative questions, loan classification and CAMEL rating.

The standards and guidance applied for both small and large LPDs are similar—an issue reflected in the way the system in general treats LPDs for liquidity exchange or training. For example, discussions with PLPDK and BPD revealed that it was rare to find qualified persons for LPD management especially in remote areas. The Muntigunung LPD was an exception—the head manager being both the village teacher and trained in accounting and bookkeeping. Despite this for smaller LPDs 'management' is not assessed as part of the modified CAMEL rating used by BPD. Capital Adequacy Ratio, a constraining measure for small village based organisations that are not raising significant deposits, is used. Guidance also focuses on these standards and is in any case limited due to the remoteness of regions such as Muntigunung, where officials find it difficult to visit on a regular basis, impacting both internal control and quality of governance.

Given the above issues are there any options for a remote MOI like the Muntigunung LPD to graduate into a more enabling institutional form? In general LPDs in Indonesia have resisted transformation. This remote LPD however actually explored the possibility of transformation in order to access on-lending funds. The LPD sought refinance from a cooperative apex (upon its advice also explored the possibility of transforming into a cooperative), but was told by members of the guidance committee that this would not be appropriate. Both the cooperative and BPD are represented in the guidance committee and this left the LPD in a difficult situation. Aside from the fact that the different views of diverse agencies in the guidance committee creates potential conflict of interest and sends mixed messages to the LPD staff, the more important issue was the lack of appropriate options for which the small LPD could transform. The cooperative is not a form to which an institution like the LPD (established under the provincial decree) can 'transform'—the need being for members of the *Desa Adat* to actually form a cooperative separately.

For small remote MOIs, transformation is one possibility to leverage external funding, aside from networking or finding diverse linkages. However even regulatory frameworks as complex as Indonesia do not necessarily provide such a graduation option.

The Government of Bali is responsible for regulating the LPD industry. However Bank Indonesia also has an interest in containing any risks to depositors. There is some cause for the regulator to push for bringing LPDs under Banking Laws—given the market penetration of the LPDs and the fact that some have grown to a size of operations (and possibly balance sheets) more like that of a small commercial bank. The current legal form of NBFC is not tightly supervised due to the highly differentiated nature of NBFCs in Indonesia and its capital requirements. Reporting requirements and available support structure suit the needs of institutions relatively much smaller than banks. Perhaps the only exception to the transformation story (or lack of) in the LPD industry is one LPD which owns a BPR—which is possible only again for the larger LPDs because the start up capital requirement for BPRs is US$5,000.

Some of the above mentioned concerns have possibly led in the past to attempts by Bank Indonesia to transform the LPDs into BPRs. This has been resisted by the LPD industry—especially the larger LPDs who are keen to retain the local roots and flexibility that the current legal vehicle provides (which is a non-bank finance company with permission to raise member deposits) and have no liquidity problems. Currently LPDs are permitted to operate as Non-Banking Finance Companies or LDKP and are allowed also to mobilize deposits from members of the *Desa Adat*, but are asked to refrain from using banking terminology (Bank Indonesia letter of 17 Feburary 1999). According to Holloh (2001), this has provided the LPD with room to move without solving the structural problem of how they can find a recognized and legalized place in the financial sector.

Furthermore, transformation to BPR may potentially limit the remote outreach of LPDs as has been seen in the case of another kind of LDKP found in Central Java, the Badan Kredit Kecamatan (BKK) which upon their transformation to BPR consolidated operations at the Kecamatan level rather than continuing to focus on the *Desa* or village and changed their product profile to suit customers at that level such as payroll deduction lending. (Patten, et al., 2003).

The issue remains of the gap of a clear graduation path and supervisory support for LPDs such that from their smallest form to one that is comparable in size to a BPR, each have the potential to grow in a sustainable way without compromising either remote outreach, access to liquidity or depositor interests.

Conclusion

LPDs offer a tremendous opportunity to reach remote areas and communities in Bali. The study of its institutional and management structure and the leveraging of an available social order to manage risk are lessons for the wider microfinance industry provided certain conditions are in place:

1) Connecting and harmonizing internal/traditional and external supervision
2) Recognizing the differing liquidity, training and supervisory needs of different sizes of LPDs
3) Stronger financial management and reporting through appropriate training and mentoring
4) Clear and distinct roles for supervisory agencies
5) Graduation/transformation options enabling small LPDs, growing LPDs and large LPDs to access suitable inputs such as refinance, and technical services without excessive external regulations

Through the above case we saw that traditional control over financial institutions can have both a good and bad influence especially in remote rural areas, where supervisory visits and capacity building may also be relatively inaccessible. The lack of balance between internal governance structure and external supervision and regulation, and overall weak supervision and guidance can have a compounded ill effect on the growth potential of a small institution already battling with challenges such as remoteness, lack of capacity and liquidity. However if a foundation of strong ownership within the community, remote outreach and good financial performance are present, steps towards correcting governance and supervision anomalies are surely worth the effort. Given the opportunities that the LPDs present for remote outreach and the comprehensive institutional framework that has been set up to support them, a few changes can go a long way in strengthening these institutions in Bali and even possibly expanding similar institutions elsewhere in the country.

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Appendix A: General Recommendations for the LPD Industry

The system needs to provide more structured options for liquidity for the LPDs. The BPD's role in liquidity management and exchange needs further attention.

Supervision needs extensive focus as currently the following issues are creating hurdles: Costs of supervision, unless covered from LPD profits, are likely to make the current system unsustainable; the involvement of multiple agencies in the system; weak reporting; lack of clear line of authority and weak link between official and traditional supervision.

The capacity building needs assessment process (as obtained from rating), supervision and training are designed to meet the needs of larger LPDs—while a vast majority of smaller institutions need careful mentoring through a cycle of growth.

In the above context the recommendations of the study team are:

- Need for a mechanism to even liquidity in the system—through flexible products like a credit line. A positive step is already in the offing with the relaxation of the need for collateral for loans below 50 million Rs. However, this is not the only hurdle in the road to accessing refinance for LPDs.
- The 2002 capitalization by the provincial government was a breath of life for many LPDs in the system. However to avoid the dependence on future injections such capitalization should be made conditional to create greater accountability. Currently it is conditional on performance but performance rating is not up to the mark.
- Review rating and guidance by differentiating between different types of LPDs. For example, management is a key criterion for rating smaller growing LPDs however the modified CAMEL tool has dropped that element. On the other hand assessing capital adequacy for the very small institutions should not be an immediate concern—and the focus on this in guidance is subtracting from the ability of the LPD to raise low cost resources locally. The rating system needs therefore to be refined and the reporting needs to be streamlined and made more efficient.
- The 2005 client satisfaction survey found that customer satisfaction was directly proportional to the size of the LPD—the larger the LPD the more satisfied its customer. This and above mentioned issues call for a two pronged approach to training and we recommend that the approach for smaller LPDs be that of mentoring and an institution building model, instead of discrete trainings.
- In line with the above there is a need for greater operational consistency— a ready reckoner in the form of operational and credit manuals (also on internal controls and lines of accountability) should be made available for which LPD staff may refer.
- A shift in the PLPDK role in guidance and capacity building in processes such as *Desa Adat* meetings, will create legitimacy and space for them to influence *Desa Adat* to help maintain internal control, create more representative governance, and mentor LPDs.
- Indonesia has one of the world's most significant success stories in savings mobilization. Despite this, the fact that LPDs are savings-based institutions and that this is their most valued service—the 'why' and 'how' of savings mobilization is weak amongst them. Some specific focus on this will help address a number of issues relating to their scope of services.

Appendix B: Methodology

Study Objective
To illustrate how varied member-owned models in different contexts have been able to achieve significant outreach in remote, rural areas.

Defining Member-owned
- Clients are both owners and users of the institution
- Member equity is tied to ownership and decision-making (shares, savings, rotating/internal capital)
- Member equity is a key source of funds
- Legal entity is based on member-owned (i.e. association)

In order to cut across models definition needs to account for a variety of forms of equity and decision-making. Even what legal entities are possible will vary from context to context.

Defining Remote
Unserved in its own market. This can be due to several factors:
- Geographical distance from nearest service or input provider
- Population density
- Socio-cultural aspects of access such as gender or ethnic background as in the case of lower castes in Asia or indigenous groups in Latin America

Study Methodology
The intention of the research is to help answer some questions about different types of member-owned institutions to determine what potential they have for depth, breadth, scope, length, worth and cost of remote outreach, using Schreiner's (1998) six aspects. In-depth institutional analysis of each MOI sample examines remote outreach and demand by remote members and member groups. The second level of analysis focuses on how remote outreach is influenced by three key drivers:
- Networking and linkages
- Governance and ownership
- Regulation and supervision

The perspective of analysis is from the lowest tier association, SACCO or set of groups and their members. Selection of case MOI(s) is based on the 20% most remote MOIs within their sample universe. Selection is based on remote members/groups that are representative and mostly strong. The sample universe would be the district, sub-region or cluster of MOIs according to second-tier organizations, political boundaries or regulatory areas. Depending on size of MOI and sample, range could be a number of self-help groups to one SACCO or village association.

Case-Selection Criteria
- Remote in terms of households is proxied by one or more of the following:
    - Location of access points (decentralized and centralized level if receiving different services at each point).
    - Distance of access points to local centre and nearest road (nature of road), availability of transportation.

  - Depth of outreach (varies by context but broadly a factor of population density and infrastructure, poverty level, and other indicators of social exclusion).
- Member-owned (not managed externally; members involved in decision-making)
- Strong breadth of outreach relative to the context
- Informative in terms of one or more of our key research questions (governance and member-participation; external resources; regulation and supervision; type of MOI)
- Not so unique or idiosyncratic that it does not have lessons that can be applied to other contexts
- Relatively financially viable
- MOI is transparent, information is readily available or fairly easily collected and staff is willing to collaborate in collecting information.

Schreiner, M. (1998). Aspects of outreach: A framework for the discussion of the social benefits of microfinance. *Journal of International Development, 14*(5), 591-603.

Appendix C: Key Financial Indicators

	1 LPD
Depth	
Avg. savings balance as % of PC GNI	24%
Avg. loan balance as a % of PC GNI	13.35%
Population density (persons per km^2)	400
No. of service providers in service area	2
% of clients who are female	25%
Length	
Operational self-sufficiency	200% (2005)
Financial self-sufficiency	195%
Portfolio at risk > 30 days	NA Repayment: 90% (2005)
Total operating expenses / avg. total assets	4%
Average staff remuneration / PC GNI	5.5%
Breadth	
Number of active borrowers	173
Number of active savers	65
Cost	
Effective interest rate	36-42%
Worth	
Retention rate	100%
Other	
Growth in total assets	NA
Net loans / total assets	76%

Notes: PC GNI refers to per capita gross national income**.** NA indicates that data is not available.