

A.I.D. EVALUATION SUMMARY - PART I

1511-52022
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1. BEFORE FILLING OUT THIS FORM, READ THE ATTACHED INSTRUCTIONS.
2. USE LETTER QUALITY TYPE, NOT "DOT MATRIX" TYPE.

IDENTIFICATION DATA

A. Reporting A.I.D. Unit: Mission or AID/W Office <u>USAID/Indonesia</u> (ES# _____)	B. Was Evaluation Scheduled in Current FY Annual Evaluation Plan? Yes <input checked="" type="checkbox"/> Slipped <input type="checkbox"/> Ad Hoc <input type="checkbox"/> Evaluation Plan Submission Date: FY <u>88</u> Q <u>2</u>	C. Evaluation Timing Interim <input checked="" type="checkbox"/> Final <input type="checkbox"/> Ex Post <input type="checkbox"/> Other <input type="checkbox"/>
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D. Activity or Activities Evaluated (List the following information for project(s) or program(s) evaluated; if not applicable, list title and date of the evaluation report.)

Project No.	Project /Program Title	First PROAG or Equivalent (FY)	Most Recent PACD (Mo/Yr)	Planned LOP Cost (000)	Amount Obligated to Date (000)
497-0341	Financial Institutions Development	84	5/91	\$23,750	\$23,750

ACTIONS

E. Action Decisions Approved By Mission or AID/W Office Director

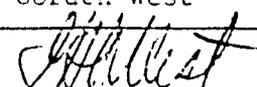
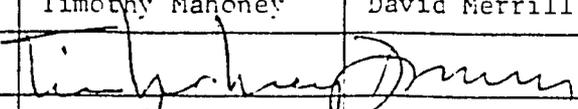
Action(s) Required	Name of Officer Responsible for Action	Date Action to be Completed
1. Decide if Bali should be added as an additional province under this project.	D. Merrill	6/88
2. Provincial training budgets should be reviewed based on project needs and expenses as part of three-year training commitment exercise.	G. West	6/88
3. Technical assistance contract should be amended to take into account evaluation recommendations.	M. Stevenson	6/88
4. Assistance to West Sumatra should be reviewed and a decision made as to future assistance or withdrawal.	G. West	6/88 & 6/89
5. USAID should urge the GOI to convene the central steering committee and to review options for assistance to other provinces outside this project.	G. West	9/88
6. West Java capitalization should be coordinated with the new advisor under project T/A.	G. West	9/88

(Attach extra sheet if necessary.)

APPROVALS

F. Date Of Mission Or AID/W Office Review Of Evaluation: _____ (Month) _____ (Day) _____ (Year)

G. Approvals of Evaluation Summary And Action Decisions:

	Project/Program Officer	Representative of Borrower/Grantee	Evaluation Officer	Mission or AID/W Office Director
Name (Typed)	Gordon West		Timothy Mahoney	David Merrill
Signature				
Date	5/11/88		5/11	

d

ABSTRACT

H. Evaluation Abstract (Do not exceed the space provided)

The goal of the Financial Institutions Development (FID) Project is to "encourage enterprise development, increase productivity and generate employment opportunities in rural areas" by supporting the development of rural credit institutions, producing loan portfolios and promoting savings mobilization. This mid-term evaluation of the FID project examined 1) the input deliveries of USAID and the Government of Indonesia, 2) progress made by village financial institutions (VFIs) and Regional Development Banks (BPDs), and 3) the original project development strategies.

The findings include: 1) A number of changes instituted in project inputs (capitalization, commodities, training and technical assistance) have resulted in a package of assistance that is appropriate and will increase the efficiency of the project. 2) VFI performance has improved during the project, but performance varies widely among the three project provinces of West Java, West Sumatra and Central Java. Central Java has shown the best performance in terms of improving its bookkeeping and reporting procedures and in its staff management. On average, FID VFIs enjoyed a significant increase in the volume of their activities since the project's inception. The volume of lending has increased by 27% per year, the number of borrowers has increased by 8%, and savings have increased by 35%. Also, substantial scope still exists for increasing the coverage of villages by FID and the demand for loans is high in all provinces. 3) Overall, improvements have been made in the quantity and quality of the supervision provided to VFIs by the BPDs. Their ability to design and implement training programs for VFI staff has also improved. However, BPD's costs for VFI supervision are greater than their interest income. In effect, the BPD's current interest rate structure means that they are subsidizing the VFIs. 4) The team found that the FID experience provides a strong basis for formulating national rural credit policies and standards, and its strategy (which involves trying to replicate and adapt the systems and procedures that have been effective in Central Java's BKK program to other provinces) may be adapted and used to develop VFIs, in the long term, throughout Indonesia.

The recommendations include: 1) USAID should maintain an active role in project implementation, consider withdrawing its support for West Sumatra's program if needed changes are not made, and expand FID to other provinces. 2) Actions should be taken to eliminate the BPD subsidy on loans to VFIs. 3) VFIs should take measures to improve their performance, including bookkeeping procedures, writing off bad debts, increasing coverage, improving policies on requiring collateral, savings withdrawal, penalties and late repayments, and providing a greater share of lending for small loans.

C O S T S

I. Evaluation Costs

1. Evaluation Team		Contract Number OR TDY Person Days	Contract Cost OR TDY Cost (U.S. \$)	Source of Funds
Name	Affiliation			
Ms. Susan Goldmark	Development Alternatives Inc. (DAI)	25	\$6,250	DAI contract
Mr. David Lucock	Private consultant	25	\$5,750	DAI contract
2 Mission/Office Professional Staff Person-Days (Estimate) _____ 5		3. Borrower/Grantee Professional Staff Person-Days (Estimate) _____ 2		

b

A.I.D. EVALUATION SUMMARY - PART II

SUMMARY

J. Summary of Evaluation Findings, Conclusions and Recommendations (Try not to exceed the three (3) pages provided)

Address the following items:

- | | |
|--|--|
| <ul style="list-style-type: none"> • Purpose of evaluation and methodology used • Purpose of activity(ies) evaluated • Findings and conclusions (relate to questions) | <ul style="list-style-type: none"> • Principal recommendations • Lessons learned |
|--|--|

Mission or Office:

USAID/Indonesia

Date This Summary Prepared:

May 5, 1988

Title And Date Of Full Evaluation Report:

Mid-Term Evaluation of the Financial Institutions Development Project. Feb. 20, 1988

PURPOSE OF EVALUATION AND METHODOLOGY USED

This mid-term evaluation of the Financial Institutions Development (FID) Project, Phase I, was conducted to address four issues: 1) the appropriateness and efficiency of USAID and Government of Indonesia (GOI) project input delivery and utilization, 2) village financial institution (VFI) efficiency, effectiveness, and financial viability, 3) Regional Development Bank (Bank Pembangunan Daerah, BPD) institutional development, and 4) the validity (or lack thereof) of original project development strategies, hypotheses, and assumptions.

The evaluation was conducted by a specialist in evaluation methodologies and credit systems, and a financial analyst and rural credit specialist. During the first week, the team held discussions with GOI and USAID officials in Jakarta. In the second and third weeks, the team visited all provinces in the project (West Sumatra, West Java, and Central Java) and the province of Bali to assess its appropriateness for inclusion in a later phase of the project. In the field, the team visited BPDs and their associated VFIs, and held discussions with BPD staff and provincial government representatives.

PURPOSE OF ACTIVITY EVALUATED

The goal of the project is "to encourage enterprise development, increase productivity and generate employment opportunities in rural areas." Its purpose is to "1) support the development of existing rural credit institutions that provide financial intermediation for village residents at reasonable cost, 2) produce loan portfolios of employment-generating activities, primarily off-farm, and 3) promote savings mobilization."

FINDINGS AND CONCLUSIONS

Are USAID and GOI Project Input Delivery and Utilization Appropriate and Efficient?

Overall, the changes instituted in project inputs have resulted in a package of assistance that is appropriate and will increase the efficiency of the project. Four inputs have been provided: funds to capitalize the VFIs, commodities (vehicles and equipment) for participating BPDs, training of BPD and VFI staff, and technical assistance provided by resident advisors in each province and local experts.

Capitalization. Under the original capitalization system, which applied to funds disbursed to Central Java and West Sumatra, USAID reimbursed BPDs for a percentage of the GOI funds disbursed to VFIs. A project amendment changed this system so that the BPDs in West and East Java receive funds directly from USAID, irrespective of the GOI contribution. The new system is thus much simpler and much less time consuming. Once a PIL and subsidiary loan agreement are in place, disbursements are fairly automatic on a quarterly basis. Although there have been some delays in receiving capitalization funds in West Java, changes in disbursement procedures should speed this process.

SUMMARY (Continued)

Commodities. The system for commodities has also been simplified. Each provincial BAPPEDA submits a commodities request to the Ministry of Home Affairs, which forwards it to USAID. If approved, commodities are procured directly by USAID and disbursed. Project commodities, in general, are now in place and being used in accordance with project requirements. The BPDs in West Sumatra and West Java are ready to computerize their management information system while Central Java is in the process of upgrading its system.

Training. The system of funds flows has been changed for FY 88-89. Under the old system, provinces prepared an annual workplan for all training activities. But the plans were overly optimistic about the speed of disbursement and the volume of training. As a result, by the end of 1987, USAID had expended only 20% of its \$2 million training budget. Under the new system, provinces will prepare a three-year training plan with a realistic implementation schedule and budget. This will give USAID a clearer picture of the needs and absorptive capacity for training BPD and VFI staff.

Technical Assistance. A full-time consultant is provided to each province. Although the workload of the Chief of Party/consultant in Central Java is excessive, BPD senior managers in all provinces praised his work. Managers in West Java expressed concern over the poor communication skills of their advisor, which they believe have seriously hampered his effectiveness. Managers in West Sumatra find that their advisor has good working relationships at the field level. The training provided by one subcontractor, Capelle Tuanakotta, appeared to be very practical and effective, but that provided by P.T. Panca Bina Esa was too theoretical and inappropriate (their contract was suspended in April 1987).

ARE THE VILLAGE FINANCIAL INSTITUTIONS RUNNING WELL?

Bookkeeping and Reporting. VFI bookkeeping and reporting systems and procedures, especially in West Sumatra and West Java, are in need of further refinement.

Personnel. Central Java has made substantial progress in replacing civil servants with full-time Badan Kredit Kecamatan (BKK) staff, which improves the BPD's control of staff performance. In West Sumatra, staff arrangements make it difficult to ensure that a satisfactory level of management is maintained.

Review of Quarterly/Semi-Annual Indicators: December 1985-June 1987.

On average, FID VFIs enjoyed a significant increase in the volume of their activities during this period. The volume of lending has increased by 27% per year, the number of borrowers increased by 8%, and savings have increased by 35%. Lending outside Central Java is moving away from the smaller loan sizes. No evidence of market saturation at the level of small loans was seen. One disturbing trend noted was that some VFIs are not focusing their loan activities on the economically weaker section of society.

The team judged that the interest rates charged by VFIs are appropriate to the recovery of their costs and the maintenance of their capital structure. Further, these rates are substantially lower than alternative credit sources at the village level.

Sustainability. In West Sumatra, loan growth exceeds income growth, while liabilities as a percentage of net worth are increasing. This is not sustainable in the long term. The effective interest rates in Central Java have maintained an asset: liability structure that can sustain the growth in lending. In West Java, where the interest rates are similar to West Sumatra's but soft loan capitalization is yet to be

SUMMARY (Continued)

realized, doubts on the sustainability of lending remain. Substantial scope still exists for increasing the coverage of villages by FID. There is still no village post system in West Java. West Sumatra has a post system but lacks a system of coordination and supervision at the sub-district level. Central Java has a village post network and continues to improve coverage. In the area of market saturation, the demand for loans is high in all provinces. In West Sumatra, borrowers often receive loans that are less than the amount requested. Village credit coverage under FID is between 16% and 34% of all villages. Central Java has initiated a voluntary savings pilot project in nine BKKs, and its BPD has decided to expand this program in FY 1988-89. Because the average savings deposit is less than U.S. \$10, these BKKs will need to attract new larger depositors to reduce administrative expenses.

ARE THE REGIONAL DEVELOPMENT BANKS EFFECTIVE?

In each province, the BPDs act as a financier to VFIs. The amount of capitalization received by a VFI is determined by its class rank. All VFIs are now being classified every six months. The number of units in West Sumatra in the better classes has declined in the last six months: it is not clear if this is due to worsening performance or better data collection. In central Java there has been a marked increase in the number of better units, while West Java has just completed its first classification of VFIs.

Administrative systems and procedures vary widely among units in West Java and West Sumatra. In some cases, guidelines exist which are not followed; in others, guidelines are incomplete. This makes field supervision more difficult and expensive; noncompliance with sound operating procedures is jeopardizing the viability of these VFIs. At present, all three BPDs' costs of VFI supervision are greater than interest income. In effect, the BPDs' current interest rate structure means that they are subsidizing the VFIs. In West Sumatra in particular, the gap between interest income and supervisory expenses is growing. Overall, however, improvements have been made in the quantity and quality of supervision provided by the respective BPDs. Their ability to design and implement training programs for VFI staff has also improved.

Training of BPD and VFI staff in West Sumatra and West Java is behind schedule. But the BPD in Central Java continues its strong commitment to staff training and has exceeded its targets. All three provinces still require continuous training at both levels.

IS THE ORIGINAL PROJECT STRATEGY VALID?

The project's strategy involves trying to replicate and adapt the systems and procedures that have been successful in Central Java's BKK program to other provinces. It also attempts to introduce a savings program to VFIs so that they can serve a financial intermediation role at the village level. Although delays have occurred in this strategy's implementation and the BKK model has required province-specific modifications, the team believes that the basic strategy is sound. An essential element of the strategy revolves around the capacity of the local BPD to supervise the VFIs carefully. This, too, has been validated during the first two years of project implementation. Overall, the FID experience provides a strong basis for formulating national rural credit policies and standards, and its strategy may be adapted and used to develop VFIs, in the long term, throughout Indonesia.

RECOMMENDATIONS

GOI and USAID. 1) The Steering Committee should be reconstituted and meet at least yearly. 2) Budgets for provincial agencies should be based on project needs and

ATTACHMENTS

K. Attachments (List attachments submitted with this Evaluation Summary; always attach copy of full evaluation report, even if one was submitted earlier; attach studies, surveys, etc., from "on-going" evaluation, if relevant to the evaluation report.)

Development Alternatives Inc. (DAI).: Mid-Term Evaluation of the Financial Institutions Development Project (Phase I). Washington, D.C.: DAI, Inc., February 20, 1988.

COMMENTS

L. Comments By Mission, AID/W Office and Borrower/Grantee On Full Report



expenses. 3) The GOI should accelerate its funding of a training center for Central Java. 4) USAID should maintain an active role in project implementation to assist the GOI in achieving policy changes to meet project objectives. 5) USAID should consider withdrawing its support for West Sumatra's FID program if changes needed to rationalize the program are not implemented in a timely manner. 6) USAID should tie the disbursement of capitalization funds to VFI performance and training progress in West Java. 7) FID should be expanded to other provinces which meet project preconditions. 8) The GOI and USAID should provide immediate and comprehensive assistance to the newly developed Bali VFI program.

BPDs. 1) Actions should be taken to eliminate the BPD subsidy on loans to VFIs, either by increasing interest income or reducing BPD administrative expenses through improved efficiency. 2) BPD/Central Java should carefully analyze the cost of collecting savings through the "Tamades" savings programs prior to expanding the program. 3) Programs to be visited as part of foreign study tours should be selected for their relevance to project participants' technical needs.

VFIs. 1) Bookkeeping and loan procedures need to be standardized for the VFIs in each province. 2) West Java needs to finalize an operating manual and encourage its use. 3) VFIs in West Sumatra and West Java should write off their bad debts and constitute provisions for doubtful loans. 4) VFIs in West Java should improve their coverage at the village level by establishing posts. 5) The policy in West Sumatra and West Java of requiring collateral on loans should be reconsidered. 6) West Sumatra should establish coordinating units at the subdistrict level to improve BPD supervision and reduce VFI administrative expenses. 7) VFIs in West Sumatra and West Java should allow borrowers to withdraw savings after their loans have been repaid or treat these payments as equity shares or membership fees. 8) Civil servants employed by VFIs in West and Central Java should be gradually replaced by trained professional managers paid for directly by the VFI. 9) West Sumatra and West Java should direct a greater share of their lending to small loans to meet the needs of village residents. 10) VFIs should enforce penalties on late repayments and/or provide incentives for prompt payment.

Technical Assistance. 1) The FID Chief of Party should be a full time-position based in Jakarta. 2) The resident advisor in Central Java should be a full time, rather than a half time, position. 3) The West Java advisor should be replaced. 4) Technical assistance to West Sumatra should be continued, either through the retention of a resident advisor or regular visits from short-term consultants. 5) Capelle & Tuanakotta should remain an integral part of the TA team. 6) The subcontract with P.T. Panca Bina Esa should be terminated.

LESSONS LEARNED

Lessons learned from the experience of the FID project indicate that certain factors play a large role in determining the relative success of VFIs. These include: 1) strong support at the highest provincial government levels, 2) good capacity of the provincial BPD to supervise VFIs, 3) services at the village level to reduce transaction costs to customers, and administration and supervision activities at the subdistrict level to optimize economies of scale, 4) separation of ownership from management of VFIs so that VFIs can be professionally managed, although locally owned, 5) VFI adherence to standard operating systems and procedures that are adapted to local conditions, 6) use of local peer group pressure and cultural mores to enforce loan repayments, 7) setting of interest rates sufficient to allow for the accumulation and attraction of funds, and 8) capacity to identify and respond to market opportunities.

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J. C. Wier

MID-TERM EVALUATION OF THE
FINANCIAL INSTITUTIONS DEVELOPMENT
PROJECT (PHASE I)



DEVELOPMENT ALTERNATIVES, INC.

MID-TERM EVALUATION OF THE
FINANCIAL INSTITUTIONS DEVELOPMENT
PROJECT (PHASE I)

by:

Susan Goldmark

David Lucock

February 20, 1988



Development Alternatives, Inc.
624 Ninth Street N.W.
Washington, D.C. 20001

Prepared under
Development Alternatives, Inc.
Contract # 497-0341-C-00-5092-00
With
The United States Agency for International Development

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PREFACE

This mid-term evaluation of the Financial Institutions Development (FID) Project, Phase I, was carried out during the inclusive period of January 26 to February 20, 1988. All the provinces in the project were visited as well as the province of Bali to assess its appropriateness for inclusion in a later phase of the project.

The evaluation focused on four main issues:

- (1) The appropriateness and efficiency of USAID and GOI project input delivery and utilization;
- (2) Village financial institution (VFI) efficiency, effectiveness, and financial viability;
- (3) Regional Development Bank (Bank Pembangunan Daerah, BPD) institutional development; and
- (4) The validity (or lack thereof) of original project development strategies, hypotheses, and assumptions.

In the first week of the mission, the team met with GOI and USAID officials in Jakarta. Valuable discussions were held with: Mr. Salim, the Head of the Bureau for Regional Development Assistance BAPPENAS, with Mr. E. Koswara, the Director for Regional Development in the Ministry of Home Affairs, with Mr. Marzuki Usman, the Head of the Directorate for Financial and Accounting Institutions in the Ministry of Finance, and with Mr. A. Warouw, the Head of the Directorate for Investment Funds in the Ministry of Finance. The team was also briefed by Mr. Gordon West, the Chief of the Employment and Enterprise Development Office as well as the FID project officer, and Mr. David Merrill, the Director of USAID/Indonesia. Discussions with Mr. Richard Patten and Mr. James Kern also enabled the team to obtain valuable insights into rural credit in Indonesia.

During the following two weeks in the field, the team visited the BPDs and their associated VFIs in the provinces of West Sumatera, West Java, Central Java and Bali. In each province the team visited and assessed representative samples of VFIs and held discussions with the staff and directors of the BPDs and with representatives from the provincial governments and BAPPEDA. The assistance provided, and interest shown in the evaluation, was greatly appreciated by the team. Upon completion of each provincial visit, a debriefing was presented by the team on its findings and recommendations followed by very positive discussions with the project's provincial administrators.

The evaluation team which was fielded by Development Alternatives Inc. (DAI) consisted of Ms. Susan G. Goldmark, team leader and specialist in evaluation methodologies and credit systems, and Mr. David A. Lucock, a financial analyst and rural credit specialist. Throughout the mission the team was accompanied by the FID project chief of party, Mr. Jay K. Rosengard who supervised the logistics of travel and meetings, assisted in language translations, and provided valuable briefings on project operations. In each province the team was also accompanied and assisted by resident FID advisors.

The mid-term evaluation was funded via the short-term technical assistance budget line item in the DAI FID I technical assistance contract, under USAID Project No. 497-0341.

Finally, the team wishes to thank the people met during the evaluation for their interest in the mission and the valuable information, discussions and assistance provided. It has been a pleasure to review a project that has shown such progress and a growing reputation in the successful development of rural financial institutions.

Susan G. Goldmark
Team Leader
February 1988

MID-TERM EVALUATION OF THE FID PROJECT:
EXECUTIVE SUMMARY (ENGLISH)

A. Findings

The experience derived from the Financial Institutions Development (FID) Project implementation provides a strong basis to formulate national rural credit policies and standards. The FID strategy may be adapted and used to develop village financial institutions (VFIs), in the long-term, throughout Indonesia. This strategy involves trying to replicate and adapt the systems and procedures that have been successful in Central Java's Badan Kredit Kecamatan (BKK) program to other provinces. The four components of project assistance used to realize this strategy are (1) funds to capitalize the VFIs, (2) commodities (vehicles and equipment) for participating Regional Development Banks (BPDs), (3) training of BPD and VFI staff and (4) technical assistance provided by resident advisors in each province and short-term technical assistance provided by local and expatriate experts. This strategy is sound and the package of assistance is appropriate.

The objective of establishing village financial institutions that provide credit for productive purposes, collect voluntary savings and are financially viable responds to an important need in rural areas of Indonesia. Lessons learned from the experience of the FID project in three provinces indicate that certain factors play a large role in determining the relative success of VFIs. These include:

- o Strong support at the highest provincial government levels;
- o Good capacity of the provincial BPD to supervise VFIs;
- o Services at the village level to reduce transaction costs to customers, and administration and supervision activities at the kecamatan level to optimize economies of scale;
- o Separation of ownership from management of VFIs so that VFIs may be professionally managed, although locally-owned;
- o VFI adherence to standard operating systems and procedures which are adapted to local conditions;
- o Use of local peer group pressure and cultural mores to enforce repayment of loans;

- o Setting of interest rates sufficient to allow for the accumulation and attraction of funds; and
- o Capacity to identify and respond to market opportunities.

Certain provinces meet these conditions better than others.

The FID project has made progress towards achieving project objectives. Improvements have been made in the quantity and quality of supervision provided by the respective BPDs. Their ability to design and implement training programs for VFI staff has also improved. However, all BPDs are subsidizing the cost of supervising VFI operations. West Sumatera and West Java fell short of BPD and VFI staff training targets; Central Java exceeded these targets. All three provinces still require continuous training at both levels.

Although the disbursement of capitalization funds was delayed in West Java, this has promoted better preparation for the receipt of these funds. Disbursement is expected to begin in March 1988. Project commodities, in general, are in place and being used in accordance with project requirements. The BPD in West Sumatera and West Java are ready to computerize their management information system while Central Java is in the process of upgrading its system.

Administrative systems and procedures vary widely among units in West Java and West Sumatera. In some cases, guidelines exist which are not followed; in others, guidelines are incomplete. This makes field supervision more difficult and expensive; noncompliance with sound operating procedures is jeopardizing the viability of these VFIs.

All VFIs are now being classified every six months. The number of West Sumatera Lumbung Pitih Nagari (LPN) units in the better classes has declined in the last six months. It is not clear whether this is due to worsening performance or better data collection. In Central Java there has been a marked increase in number of better units during the project. West Java has only just completed its first classification of VFIs.

The volume of lending has increased by 27% per year since project inception, numbers of borrowers increased 8%, and savings have increased 35% during the same time. Lending outside Central Java is moving away from the smaller loan sizes. No evidence of market saturation at the level of small loans was seen.

Interest rates charged by VFIs are appropriate to the recovery of their costs and the maintenance of their capital structure. These rates are substantially lower than alternative credit sources at the village level.

Substantial scope still exists for increasing the coverage of villages by FID. There is no village post system in West Java. The LPN, by virtue of their number of units, have a post system but lack a system of coordination and supervision at the kecamatan level. Central Java, which already has a village post network, continues to improve coverage.

Central Java has initiated a voluntary savings pilot project in nine BKKs. The BPD has decided to expand this program to all 400 Class I, II and III BKK in FY 1988-89. Since the average savings deposit is less than US\$ 10, these BKKs will need to attract large depositors to reduce administrative expenses.

B. Recommendations

GOI and USAID

- o The Steering Committee should be reconstituted and meet at least once each year to review project progress and provide policy guidance;
- o Budgets for provincial agencies should be based upon project needs and corresponding expenses;
- o GOI should accelerate its funding of a training center for Central Java to enable completion within the next two years;
- o USAID should maintain an active role in project implementation to assist the GOI in achieving policy changes to meet project objectives;
- o USAID should consider withdrawing its support for West Sumatra's FID program if changes needed to rationalize the program are not implemented in a timely manner;
- c USAID should tie the disbursement of capitalization funds to VFI performance and training progress in West Java;
- o The FID program should be expanded to other provinces which meet the preconditions discussed previously; and
- o The GOI and USAID should provide immediate and comprehensive assistance to the newly-developed Bali VFI program.

BPDs

- o Actions should be taken to eliminate the BPD subsidy on loans to VFIs. This can be accomplished either by increasing interest income or by reducing BPD administrative expenses through improved efficiency;
- o The BPD/Central Java should carefully analyze the cost of collecting savings through the "Tamades" savings program prior to expanding the program to all Class I, II and III units; and
- o Programs to be visited as part of foreign study tours should be carefully selected so that they are relevant to technical needs of project participants.

VFIs

- o Bookkeeping and loan procedures need to be standardized for the VFIs in each province;
- o West Java needs to finalize an operating manual and encourage its use through a vigorous training program;
- o VFIs in West Sumatra and West Java should write-off their bad debts and constitute provisions for doubtful loans;
- o VFIs in West Java should improve their coverage at the village level by establishing posts;
- o The policy in West Sumatra and West Java of requiring collateral on loans should be reconsidered;
- o West Sumatra should establish coordinating units at the kecamatan level to improve BPD supervision and reduce VFI administrative expenses;
- o VFIs in West Sumatra and West Java either should allow borrowers to withdraw savings after their loans have been repaid or treat these payments as equity shares or membership fees;
- o Civil servants employed by VFIs in West and Central Java should be gradually replaced by trained professional managers paid for directly by the VFI. This can only be accomplished after the VFI can support this expense;

- o West Sumatera and West Java should direct a greater share of their lending to small loans to meet the needs of village residents; and
- o VFIs should enforce penalties on late repayments and/or provide incentives for prompt payment.

Technical Assistance

- o The FID Chief of Party should be a full-time position and based in Jakarta. Chief responsibilities should include supervising and monitoring activities in FID-assisted provinces, visiting other provinces to analyze the potential of including them under the FID umbrella, conferring with GOI and USAID officials on project policy and implementation issues;
- o The resident advisor for BPD/Central Java should be a full rather than half-time position. This advisor is needed to help in the expansion of the savings program, provide advice on reviving urban BKK, improve collection rates and computerize the management information system;
- o The West Java resident advisor should be replaced with someone with greater Indonesian language ability and better understanding of the local context;
- o Technical assistance to West Sumatera should be continued either through retention of a resident advisor or regular visits from short-term consultants;
- o Capelle & Tuanakotta should remain an integral part of the technical assistance team due to BPD and VFI enthusiastic response to training undertaken to date; and
- o The subcontract with P.T. Fanca Bina Esa should be terminated due to poor performance and consequential lack of demand for its services.

**Mid-Term Evaluation of the FID Project :
Executive Summary (Indonesian)**

RINGKASAN EKSEKUTIF

A. Kesimpulan

Pengalaman yang dapat ditarik dari pelaksanaan Proyek Pengembangan Lembaga Keuangan (Financial Institutions Development, FID) memberikan landasan yang kuat untuk merumuskan kebijaksanaan-kebijaksanaan dan patokan-patokan kredit pedesaan nasional. Strategi Proyek FID dapat disesuaikan dan digunakan untuk mengembangkan Lembaga Keuangan Pedesaan (Village Financial Institutions, VFI), dalam jangka-panjang, di seluruh Indonesia. Strategi ini mencakup upaya mencontoh dan menyesuaikan sistem-sistem dan prosedur-prosedur yang telah berjalan dengan sukses dalam program Badan Kredit Kecamatan (BKK) Jawa Tengah bagi daerah-daerah Tingkat I lainnya. Keempat komponen bantuan proyek yang digunakan untuk mewujudkan strategi ini adalah (1) modal untuk kapitalisasi VFI, (2) komoditi (sarana-sarana dan peralatan untuk mengikutsertakan Bank Pembangunan Daerah, BPD), (3) latihan bagi staf BPD dan VFI, dan (4) bantuan teknik yang diberikan oleh para konsultan tetap di tiap propinsi dan bantuan teknik jangka-pendek yang diberikan oleh konsultan domestik dan asing. Strategi ini sehat dan paket bantuannya layak.

Maksud pendirian lembaga-lambaga keuangan desa yang memberikan kredit bagi tujuan-tujuan produktif, menghimpun tabungan-tabungan sukarela dan yang dapat terus berjalan secara finansial adalah memenuhi suatu kebutuhan penting di wilayah-wilayah pedesaan Indonesia. Pelajaran yang dapat ditarik dari pengalaman proyek FID di tiga propinsi menunjukkan adanya faktor-faktor tertentu yang memainkan peranan besar dalam menentukan keberhasilan relatif VFI. Faktor-faktor itu ialah:

- o Dukungan kuat di tingkat-tingkat tertinggi pemerintahan daerah Tk. I (propinsi);
- o Kemampuan baik BPD propinsi untuk mengawasi VFI-VFI;
- o Pelayanan bagi para nasabah di tingkat desa untuk memperkecil biaya-biaya transaksi, sedangkan kegiatan administrasi dan pengawasan di tingkat kecamatan untuk mendayagunakan penghematan yang sebesar-besarnya;
- o Pemisahan pemilikan dari manajemen VFI sehingga VFI dapat dikelola secara profesional, walaupun merupakan milik desa setempat;

- o Keterkaitan VFI pada sistem-sistem dan prosedur-prosedur operasional yang baku yang disesuaikan pada kondisi setempat;
- o Penggunaan penekanan kelompok setingkat dan adat-istiadat budaya setempat untuk menegakkan kewajiban pembayaran kembali pinjaman;
- o Penetapan tingkat bunga yang memadai untuk memungkinkan akumulasi dan penghimpunan dana; dan
- o Kemampuan mengenali dan memanfaatkan peluang-peluang pasar.

Propinsi-propinsi tertentu menghadapi kondisi-kondisi ini secara lebih baik daripada propinsi-propinsi lainnya.

Proyek FID telah membuat kemajuan ke arah pencapaian tujuan-tujuan proyek. Sementara itu telah dilakukan perbaikan-perbaikan dalam kuantitas dan kualitas pengawasan yang diadakan oleh masing-masing BPD. Kemampuan mereka merancang dan melaksanakan program-program latihan bagi para anggota staf VFI juga mengalami peningkatan. Tetapi, semua BPD memberikan subsidi biaya pengawasan operasi-operasi VFI. Sumatera Barat dan Jawa Barat tidak mencapai sasaran-sasaran latihan staf VFI dan BPD; dalam pada itu Jawa Tengah melampaui sasaran-sasaran ini. Ketiga propinsi ini semuanya masih memerlukan latihan yang terus-menerus pada kedua tingkat tersebut.

Walaupun pengeluaran dana-dana permodalan di Jawa Barat mengalami penundaan, hal ini malahan meningkatkan persiapan yang lebih baik bagi penerimaan dana-dana tersebut. Pengeluaran dana itu diharapkan dimulai dalam Maret 1988. Komoditi proyek, pada umumnya, tersedia di tempatnya dan dipergunakan sesuai dengan persyaratan proyek. BPD di Sumatera Barat dan Jawa Barat sudah siap melaksanakan komputerisasi bagi sistem-sistem informasi manajemen mereka, sedangkan Jawa Tengah berada dalam proses peningkatan sistemnya.

Di Jawa Barat sistem-sistem dan prosedur-prosedur administrasi di kalangan unit-unitnya sangat berbeda-beda, demikian juga di Sumatera Barat. Dalam beberapa hal, garis-garis pedoman sudah ada tetapi tidak diikuti; dalam hal-hal lainnya, garis-garis pedoman tidak lengkap. Keadaan ini membuat pengawasan lapangan menjadi lebih sulit dan mahal; tak ditaatinya prosedur-prosedur operasi yang schat akan membahayakan kelangsungan hidup VFI.

Sekarang ini semua VFI diklasifikasi setiap enam bulan. Jumlah unit Lumbung Pitih Nagari (LPN) Sumatera Barat yang berada pada kelas lebih baik telah menurun dalam enam bulan terakhir.

Tidaklah jelas apakah hal ini dikarenakan prestasi yang memburuk ataukah penghimpunan data yang lebih akurat. Di Jawa Tengah, terjadi suatu peningkatan yang mencolok dalam jumlah unit yang lebih baik selama proyek berlangsung. Jawa Barat baru saja menyelesaikan klasifikasi VFI-nya yang pertama.

Jumlah pinjaman telah meningkat 27% per tahun sejak adanya proyek tersebut, dan jumlah peminjam naik 8%, sedangkan tabungan meningkat 35% selama waktu yang sama. Pinjaman di luar Jawa Tengah sedang bergeser dari pinjaman kecil. Tak ada bukti yang menunjukkan adanya kejenuhan pasar pada tingkat pinjaman kecil.

Tingkat bunga yang dikenakan oleh VFI adalah layak bagi penggantian biaya yang telah dikeluarkan dan pemeliharaan struktur permodalan mereka. Pada hakekatnya tingkat-tingkat bunga ini lebih rendah daripada sumber-sumber kredit alternatif di tingkat desa.

Masih terdapat peluang yang besar untuk meningkatkan peliputan desa-desa oleh VFI. Di Jawa Barat tidak ada sistem pos desa. LPN di Sumatera Barat, berkat jumlah unitnya, memiliki sistem pos desa tetapi tidak memiliki sistem koordinasi dan pengawasan pada tingkat kecamatan. Jawa Tengah yang sudah memiliki jaringan pos desa dapat terus-menerus meningkatkan peliputannya.

Jawa Tengah telah memrakarsai sebuah proyek perintis tabungan sukarela di sembilan BKK. BPD-nya telah memutuskan untuk memperluas program ini ke seluruh 400 DKK kelas I, II dan III selama Tahun Anggaran 1988-89. Mengingat deposito tabungan rata-rata adalah kurang dari US\$ 10, maka BKK-BKK ini akan memerlukan menarik depositor dalam jumlah besar guna memperkecil biaya administrasi.

B. Rekomendasi

Pemerintah Indonesia dan USAID

- o Panitia Pengarah (Steering Committee) hendaknya dibentuk kembali dan bersidang sedikitnya sekali tiap tahun untuk melakukan tinjauan terhadap kemajuan proyek dan memberikan bimbingan kebijaksanaan;
- o Anggaran bagi badan-badan tingkat propinsi hendaknya didasarkan atas kebutuhan-kebutuhan proyek dan biaya yang sesuai dengan kebutuhan itu;

- o Pemerintah Indonesia hendaknya mempercepat pengeluaran dananya bagi pembiayaan sebuah pusat pendidikan dan latihan untuk Jawa Tengah guna memungkinkan penyelesaian pembangunannya dalam waktu dua tahun yang akan datang;
- o USAID hendaknya tetap memainkan peranannya yang aktif dalam pelaksanaan proyek guna membantu Pemerintah Indonesia mencapai perubahan-perubahan kebijaksanaan agar tujuan-tujuan proyek terpenuhi;
- o USAID hendaknya mempertimbangkan penarikan dukungannya pada Proyek FID di Sumatera Barat apabila perubahan-perubahan yang diperlukan untuk merasionalisasikan program LPN tidak terlaksanakan sesuai dengan waktu yang telah ditetapkan;
- o USAID hendaknya mengaitkan pengeluaran dana permodalan pada perkembangan VFI dan kemajuan latihannya di Jawa Barat;
- o Proyek FID hendaknya diperluas ke propinsi-propinsi lainnya yang memenuhi syarat seperti yang dibahas di muka; dan
- o Pemerintah Indonesia dan USAID hendaknya memberikan bantuan segera dan yang mencakup banyak hal (komprehensif) kepada program VFI Bali yang baru dikembangkan.

Bank Pembangunan Daerah

- o Hendaknya diambil tindakan untuk meniadakan subsidi BPD mengenai pinjaman kepada VFI-VFI. Hal ini dapat dilakukan baik dengan memperbesar pendapatan bunga pinjaman atau dengan memperkecil biaya administrasi BPD melalui efisiensi yang disempurnakan;
- o BPD Jawa Tengah hendaknya dengan cermat menganalisa biaya penghimpunan tabungan melalui program tabungan TAMADES sebelum memperluas program tersebut ke semua unit kelas I, II dan III; dan
- o Program-program yang akan ditinjau orang asing dalam rangka studi perbandingan (study tour) mereka hendaknya diseleksi secara cermat sehingga program-program itu benar-benar ada kaitannya (relevan) dengan kebutuhan teknis para peserta proyek.

Lembaga-Lembaga Keuangan Pedesaan (VFI)

- o Prosedur pembukuan dan pinjaman di kalangan VFI-VFI di setiap propinsi perlu diseragamkan (distandarisasikan);
- o Jawa Barat perlu menyelesaikan buku pedoman operasi dan menganjurkan pemakaiannya melalui sebuah program latihan yang giat;
- o VFI-VFI di Sumatera Barat dan Jawa Barat hendaknya menghapuskan hutang-hutang yang macet dan menetapkan cadangan penghapusan pinjaman yang diragukan;
- o VFI-VFI di Jawa Barat hendaknya meningkatkan peliputan mereka di tingkat desa dengan mendirikan pos-pos desa;
- o Kebijakan mensyaratkan jaminan atas pinjaman yang berlaku di Sumatera Barat dan Jawa Barat hendaknya dipertimbangkan kembali;
- o Sumatera Barat hendaknya mendirikan unit-unit koordinasi di tingkat kecamatan guna meningkatkan pengawasan BPD dan mengurangi biaya-biaya administrasi VFI;
- o VFI-VFI di Sumatera Barat dan Jawa Barat hendaknya membolehkan peminjam menarik tabungan wajib setelah melunasi pinjamannya atau memperlakukan pembayaran ini sebagai pemegang saham atau iuran keanggotaan;
- o Pegawai negeri sipil yang dipekerjakan oleh VFI di Jawa Barat dan Jawa Tengah hendaknya secara bertahap digantikan oleh petugas yang murni dan profesional, yaitu yang terlatih dan yang digaji langsung oleh VFI. Ini hanya dapat dilakukan apabila VFI sudah dapat menanggung sendiri pengeluaran ini (mandiri);
- o Sumatera Barat dan Jawa Barat hendaknya menyalurkan bagian lebih besar dari pinjaman yang mereka berikan dalam bentuk pinjaman kecil guna memenuhi kebutuhan masyarakat pedesaan; dan
- o VFI-VFI hendaknya memberlakukan tindakan hukuman terhadap pelunasan terlambat dan/atau memberikan perangsang (insentif) bagi pembayaran kembali tepat pada waktunya.

Bantuan Teknis

- o Jabatan Ketua Tim Konsultan Proyek FID hendaknya merupakan jabatan penuh-waktu (full-time) dan berkedudukan di Jakarta. Tanggungjawabnya yang utama mencakup kegiatan pembinaan dan pemantauan di propinsi-propinsi yang dibantu Proyek FID, mengunjungi propinsi-propinsi lainnya untuk menganalisa kemungkinan memasukkan propinsi-propinsi itu ke dalam lingkungan di bawah payung Proyek FID, berunding dengan para pejabat Pemerintah Indonesia dan USAID mengenai kebijaksanaan proyek dan masalah-masalah pelaksanaannya;
- o Konsultan tetap bagi BPD Jawa Tengah hendaknya merupakan jabatan penuh-waktu daripada jabatan penggal-waktu (part-time). Konsultan ini diperlukan untuk membantu dalam perluasan program tabungan sukarela, memberikan nasehat mengenai penggiatan kembali BKK daerah perkotaan, memperbaiki tingkat penghimpunan tabungan dan mengusahakan komputerasi dalam sistem informasi manajemen;
- o Konsultan tetap Jawa Barat hendaknya digantikan oleh seseorang yang berkemampuan lebih besar dalam berbahasa Indonesia dan memiliki pengertian yang lebih baik mengenai keadaan setempat;
- o Bantuan teknis kepada Sumatera Barat hendaknya dilanjutkan dengan tetap menempatkan seorang konsultan tetap atau pengadaan kunjungan teratur oleh konsultan-konsultan jangka-pendek;
- o Capelle & Tuanakotta hendaknya tetap menjadi bagian yang tak terpisahkan dari tim bantuan teknis karena adanya tanggapan yang antusias dari BFD dan VFI terhadap latihan yang diselenggarakan hingga kini; dan
- o Subkontrak dengan P.T. Panca Bina Esa hendaknya dihentikan saja, karena prestasinya yang rendah dan kurangnya permintaan akan pelayanannya sebagai akibatnya.

MID-TERM EVALUATION OF THE FID PROJECT : TEXT

I. Project Design

A. General Project Description and Strategy

1. Project Goal and Purpose

The goal of the Financial Institutions Development Project (FID), according to the Project Paper, is "to encourage enterprise development, increase productivity and generate employment opportunities in rural areas." Its purpose is to "1) support the development of existing rural credit institutions that provide financial intermediation for village residents at reasonable cost, 2) produce loan portfolios of employment-generating activities, primarily off-farm and 3) promote savings mobilization." The end of project status is the development of four self-sustaining, locally oriented financial systems that mobilize savings and extend credit. The FID project should enable senior decisionmakers to develop the policies, systems and standards required to promote the growth of village financial institutions.

Although the mid-term evaluation team did not conduct a formal survey of borrowers, conversations with village financial institution (VFI) staff and some borrowers indicate that loans are, in general, being used for productive off-farm purposes. Since the volume of outstanding loans has increased steadily without a significant deterioration of loan portfolio quality, this indicates that the rate of return on activities financed through VFI loans is at least equivalent to the interest charged. The team found no evidence that borrowers were forced to sell other assets to meet their VFI loan obligations -- often the case with funds borrowed from traditional rural moneylenders. The project's impact on employment is unknown, but high effective interest rates normally encourage investment in labor-intensive activities.

Achieving the project's goal is dependent upon strengthening VFIs so that they have wide coverage in a financially viable manner. Areas which have (a) larger, growing VFIs and (b) a high ratio of VFIs to villages can be presumed to have more positive impact than those with primarily weak (or dead) VFIs. Central Java best fulfills these two criteria. But achieving both of these objectives in the two other FID-assisted provinces may be impossible in the short-run without a fundamental change in priorities. Although West Sumatra has 584 registered VFIs, only about 130 were actually functioning as of December 1987. West Sumatra has neither high coverage nor dynamic units. West Java,

on the other hand, has growing units but lacks coverage at the village level. A key project issue is whether to concentrate resources on improving the position of live, weaker units or to resuscitate dead units as well.

The end of project status is unclear on this point. After two years of project implementation, it appears to be more cost-effective to concentrate resources on improving VFIs with mediocre to good performance than on reviving dead units. In West Sumatera, the provincial government has focused on creating new units or reviving dead ones; during this time half of the better units (Class I-III) declined to Class IV or V status. We suggest that the project's success should be judged more on the quality of VFI performance than the sheer quantity of existing VFIs.

To be self-sustaining, VFIs' interest income must be high enough to cover cost of funds, administrative costs and losses due to bad debts. While VFIs can pay current rates charged on BPD loans, these rates appear to be subsidized by the BPDs. The interest rates charged by BPDs in all three provinces provide insufficient income to cover their VFI-related administrative expenses. In West Sumatera this problem is exacerbated because the provincial government receives a share of interest income to cover its expenses. As USAID capitalization funds enter the system, interest income to BPDs should increase, thereby improving this situation. A desirable end of project status objective would be to eliminate this subsidy -- either by increasing interest income or by reducing BPD administrative expenses through improved efficiency.

Since West Sumatera and West Java VFIs do not write-off bad debts or constitute provisions for doubtful loans, income and assets are overstated. This makes it difficult to analyze the true financial performance of units in these provinces. The BKK in Central Java have begun to write-off bad debts and constitute provisions. The other two provinces are supposed to receive training and adopt these procedures in 1988. By early 1989, it should be possible to evaluate the VFIs true financial performance and determine whether they are self-sustaining.

Another end-of-project objective is for village financial institutions to be locally oriented. One key to high repayment rates is that VFIs are integrated within the local community. Although the BKKs in Central Java are owned by the provincial government, which provides a legal basis for standardizing the program, they are locally oriented. Village posts are used to reduce administrative costs by servicing villages on a weekly basis. West Sumatera does not have a village post system; each VFI is owned by its members based in the traditional village group (Nagari). This local ownership is both the strength and a source of problems for the VFIs. Since these institutions are

locally-owned, it is difficult to enforce managerial and procedural changes suggested by the provincial government and the BPD. Managers of VFIs in West Sumatera are chosen by the Nagari members and often lack the technical qualifications needed to manage such institutions.

The Bank Karya Produksi Desa (BKPD) in West Java are owned by the district government (kabupaten) while the Lembaga Perkreditan Kecamatan (LPK) are jointly owned by the district and provincial governments. Village financial units in West Java, in contrast, are located at the kecamatan rather than village level. It will be difficult to compete with other financial institutions at that location since VFI interest rates are higher than their main competitors - the Bank Rakyat Indonesia (BRI) unit desa and the Koperasi Unit Desa (KUD). Both the VFI and the BRI require collateral and have similar loan sizes; the KUD is a conduit for subsidized agricultural credit. The challenge for West Java VFI will be to expand into a system of village posts where they can fill a gap in the market.

All three provinces have savings programs. The BPD in Central Java launched a pilot project for voluntary savings in mid-November 1987. Nine units which had reached their BPD credit ceilings were chosen to test the savings campaign. Positive results have caused the BPD/Central Java to plan the expansion of voluntary savings to 400 of the healthier units (Class I-III) in FY 88-89. The small average size of a BKK savings account (under US\$ 10) indicates that BKK will have to attract larger savers (for example: village development funds) to reduce their administrative costs. The LPN in West Sumatera and the LPK in West Java also started to collect savings on an ad hoc basis. The BKPD in West Java, as secondary banks, have had savings since their inception. Results from Central Java will be analyzed prior to formal extension of voluntary savings to the LPN and LPK.

All three provinces also have a forced savings component to loan repayment. Only in Central Java have VFIs begun to return forced savings after the clients have repaid their loans. In the other two provinces, forced savings often are not returned. It is highly recommended that VFIs in West Sumatera and West Java either allow borrowers to withdraw forced savings upon full loan repayment or treat these payments as equity shares, membership fees or income to the units.

2. Conditions Precedent and Covenants

The project has relatively few conditions precedent and covenants. The conditions precedent for initial funds disbursement was for the BPDs in West Sumatera and West Java to assign five full-time staff members to supervise the VFI units.

In addition, at least two full-time professionals within the Home Affairs Directorate for Regional Development (BANGDA) had to be assigned as part of a rural credit team. These conditions were set because of importance of BPD supervision and government commitment to project success.

The two BPDs met these conditions before FID began. Although BANGDA has assigned FID planning and supervision responsibilities to several individuals within one section of BANGDA, no staff members are devoted exclusively to FID. This will be sufficient once efficiency is increased through partial computerization.

The condition precedent for disbursement of funds for system capitalization involved having the GOI describe procedures for transfer of funds between Ministry of Finance, BPDs and VFIs. The second condition was that the GOI had to agree to "take the necessary steps to allow village-based credit systems in this project to accept voluntary savings from borrowers and non-borrowers in the project area and safeguard such savings through procedures reflecting unit performance." This second condition was inappropriate and was eliminated for West Java and East Java in the project amendment. Before a voluntary savings program is launched, VFI management must receive training in funds mobilization and management. Only stronger units should be allowed to mobilize savings since such programs require careful supervision. In addition, as stated in the project amendment, VFIs require start-up capital before they are in a position to support a savings program.

The condition precedent for computer related equipment was reasonable. The GOI was required to submit an assessment of BPD computer needs in the three project provinces. This was completed in late 1987.

The project has two important covenants. The GOI had to agree "to structure accounting practices and interest rates under this project to ensure the financial viability of each of the particular village credit systems with accounting practices including procedures to reserve funds for loan losses and to write-off uncollectable loans." Improvements have been made in restructuring accounting practices and standardizing interest rates. Lending rates are high enough to allow efficiently-managed VFIs to be financially viable, assuming low default rates. As mentioned previously, permission to write-off uncollectable loans is unclear in West Java and West Sumatera. While these provinces will receive training in how to write-off loans in FY 1988-89, it is not certain that they will actually implement these practices. We strongly recommend that this covenant be complied with as soon as staff have completed their training.

The Badan Pembinaan Pembangunan Kredit Pedesaan (Steering Committee for Rural Credit Development) was supposed to meet at least once a year to review project performance. This policy-making body has never met. An ad-hoc team representing this body met with the evaluation team to discuss the results of this study in February 1988. We believe that this body can play an important part in project implementation. It should be reconstituted and meet every year.

B. Validity of Project Strategy, Hypotheses and Assumptions

The project's basic strategy involves trying to replicate and adapt the systems and procedures that have been successful in Central Java's BKK program to other provinces. It also attempts to introduce a savings program to VFIs so that they can serve a financial intermediation role at the village level. The four components of USAID assistance used to realize this strategy are (1) funds to capitalize the VFIs, (2) commodities (vehicles and equipment for participating BPDs), (3) training of BPD and VFI staff and (4) technical assistance provided by resident advisors in each province and short-term technical assistance provided by local and expatriate experts.

Although delays have occurred in the implementation of this strategy and differing economic conditions, local customs and organizational structures require the BKK model to be adapted to each province's conditions, we believe that the basic strategy is sound. An essential part of this strategy revolves around the capacity of the local BPD to supervise VFIs carefully. This, too, has been validated during the first two years of project implementation.

Key project assumptions stated in the Project Paper's logical framework to achieve the project purpose and goal include maintaining flexible interest rates, continuing decentralization and adopting positive rates on savings. These assumptions have been realized. Other assumptions implicit in the analysis conducted for the Project Paper are that an unmet demand for credit exists in rural areas. Specifically:

- o "Interest rates above the conventional rates are acceptable and offer the borrower a reasonable rate of return," and
- o "Demand for loan funds at these rates exists in other villages within current geographical operating areas."

All three assumptions appear to be true since outstanding loans have increased at an annual compounded rate of 25, 28, 36 and 43 percent among the BKK, LPN, LPK, BKPD, respectively from December 1985 - June 1987. Interest rates compare favorably with

those available at the village level from traditional moneylenders. In Central Java, the monthly effective rate charged by a local cooperative, KOSIPA, the chief alternative to VFI loans, is about 47.5 percent. In comparison, the BKK program charges a monthly effective interest rate of about 7.5 percent on its most popular "Mingguan" loan (repayment each week, loan term of three months, 10 percent forced savings, 10 percent interest). This effective rate drops in half if repayments are not made until the last payment is due. Since there has been no standard penalty for late payments (or rewards for on-time repayments) the interest rate is much lower than alternative sources at the village level. Central Java is planning to introduce rebates for timely repayment.

Strong demand for loan funds appears to exist in areas not covered by existing VFIs. Bitter experience gained in the BKK program suggests that village financial institutions should be located in areas with a concentration of borrowers also involved in off-farm activities rather than purely agricultural activities.

Project Paper assumptions were overly optimistic with respect to the growth of the program. The economic analysis projected that outstanding loans would increase between 44-55 percent per annum. These targets were unrealistically high, given the need to maintain portfolio quality. The Project Paper also did not anticipate the intensive training of VFI staff needed before a voluntary savings program should begin.

C. Project Paper Amendment

In July 1987, the FID project was amended to add East Java as a fourth province to receive AID assistance. The second major change was to reduce loan funds for the BPD component by \$4.75 million. Funds were reduced because the technical assistance contract was lower than budgeted, the devaluation of the rupiah has reduced costs and provincial training programs began later than anticipated and cost less than anticipated. A third change was to change capitalization procedures for West Java and East Java. These procedures are discussed in a subsequent section.

D. Project Budget

Annexes A and B present the budgets shown in the Project Paper and the Project Amendment. Resources are adequate to fund activities described in the Project Paper.

II. Project Structure and Procedures

A. Institutional Roles and Responsibilities of Project Implementors

1. Central Government of Indonesia Agencies and USAID

The establishment of a Steering Committee to assess project progress and set policy guidelines would help foster VFI development. We suggest that this covenant be complied with and include representatives from the Ministry of Home Affairs (BANGDA and the Directorate for Government Affairs and Regional Autonomy; PUOD), Ministry of Finance, Bank Indonesia, National Development Planning Board (BAPPENAS) and USAID.

The Ministry of Home Affairs is the FID implementing agency within the Government of Indonesia. When FID was designed, it considered as a component of general area development; it was, therefore, placed within the Directorate General in the Ministry of Home Affairs which is in charge of general regional development. The FID-assisted rural financial institutions have graduated from a pilot project status to becoming permanent legal entities (BUMDs, state-owned enterprises) under the technical supervision of the BPDs. In the longer term, it might be more logical to place oversight of these activities within the Directorate General of Home Affairs which deals with BPD development, PUOD. BANGDA, given its long experience with this program, should continue to remain involved in policy guidance by serving on the steering committee.

The Ministry of Finance has three primary functions relating to the FID project:

- o Reviewing and processing annual project budgets (Directorate General of the Budget);
- o Processing of subsidiary loan agreements between the Ministry of Finance and provincial governments for capitalization funds (Directorate of Investment Funds); and
- o Granting permission for non-banks to accept voluntary savings and general guidance on non-bank institutional development (Directorate of Financial and Accounting Institutions).

The Ministry of Finance has played a constructive role in carrying out its responsibilities under the project. Some delays and misunderstanding have occurred due to poor coordination with other FID implementing agencies. In the future, it is highly

recommended that representatives from the directorates of the Ministry of Finance involved in FID implementation be active participants in all stages of project implementation.

BAPPENAS' role is to ensure that FID is in keeping with national development strategy and programs. BAPPENAS' support has been critical for timely project development. For example, the GOI's support to the FID project increased to Rp. 1.7 billion in FY 88/89 despite an austere national budget.

Bank Indonesia was not originally included as an active project participant. As lessons from FID are translated into national banking policy, its role in project expansion and implementation will become more important.

USAID/Jakarta has played an important role to ensure that the project has been implemented according to its design and in accordance with project objectives. USAID has leveraged institutional change in West Java through the strategic application of external resources. For example, it has promoted the gradual adoption of a common set of supervision and administration systems among the LPK and BKPD. In West Sumatera, USAID is promoting a high level policy dialogue about the long-term potential for growth and sustainability without substantial change in LPN institutional and legal systems.

For the project to meet its potential as a catalyst, USAID must maintain an active role in project implementation with the GOI. If project administration tasks become too onerous, USAID should consider streamlining systems and procedures to make the maximum use of existing staff resources instead of diminishing its role.

2. Provincial Agencies: BAPPEDA, SETWILDA, BPD

Support from the provincial government is a key ingredient in the success of the VFI rural credit programs. This is especially true in areas where VFI village members vote on policies which are adopted by consensus. The provincial government must clarify the lines between ownership and management so that BPD supervision advice is adopted. A balance must be sought between owners' rights and provincial-wide development.

The relationship among the Provincial Development Planning Board, the Secretariat of the Provincial Government (SETWILDA) and BPD was defined in a letter from the Director General of BANGDA to the provinces in 1985. This was formalized in a Ministerial instruction ("juklak") issued by the Minister of Home

Affairs in December 1987. According to this document, BAPPEDA is in charge of coordinating project implementation, SETWILDA deals with organizational issues and provides support for infrastructure development. BPD is responsible for technical supervision and oversight, including implementation of training programs and improvement of VFI bookkeeping and administration systems. Each of these three institutions is required to appoint a project manager (pimpro) who is responsible for supervising project implementation. A provincial steering committee (Badan Pembina Proyek FID) is responsible for coordination among respective FID implementors.

Until the issuance of this document, there was some confusion in certain provinces over the authority and responsibilities of FID implementing organizations. West Java presented another complicating factor: Bank Indonesia delegated to BRI supervision of secondary banks, including the BKPDs. Thus, the relationship between authority and responsibility of the BRI and BPD supervisors has been unclear. An oral agreement was reached in late 1987 which specified that BPD has the right to enter all BKPDs for two reasons: on behalf of the VFI's owner (the local government) and as a lender. This agreement should eliminate confusion between the two institutions.

Central Java's BKK program has enjoyed support at the Governor's level since its founding. The program adopted interest rates high enough to cover all expenses when heavily subsidized interest rates were the rule for government credit programs. The program still enjoys high visibility and support within the local government. The supervision provided by BAPPEDA is minimal and appears adequate; it should provide general oversight and coordination and not line technical supervision. Given these responsibilities, it seems excessive to finance four full-time staff and three project vehicles under the FID project. (Two of these vehicles have already been bought with GOI funds and a third is being requested). BAPPEDA's budget is calculated as a percentage of the total FID project budget for Central Java. The current guideline is for BAPPEDA to receive seven percent of FID's budget, although only three percent has actually been allocated. We believe that BAPPEDA's budget should not be a fixed percentage of project costs, but rather reflect the costs actually needed to fulfill its coordinating responsibilities. Most of these coordination responsibilities should be supported primarily from its routine budget.

In West Sumatera, lack of clarity about the respective authority and responsibilities of project implementors has negatively affected project implementation. This has resulted in a lack of initiative to confront and resolve fundamental structural problems of the LPNs. The determination of a cost-effective organizational structure for LPNs has been delayed and project coordination, legal sanctions and monitoring and

supervision activities have been inhibited due to this lack of clarity. VFIs have, on occasion, received conflicting advice from different project agencies, resulting in confusion and delays in the drawdown of softloan funds. A meeting held in mid-February between head office BANGDA staff and provincial project implementors appears to have resolved many of the above issues. However, progress towards the implementation of these decisions must be carefully monitored. Village financial institutions should be consolidated for supervision purposes, lending opened up to smaller borrowers and focus placed on supporting stronger units rather than reviving dead VFIs or creating new ones. If positive changes do not occur in a timely manner, USAID should consider withdrawing its support for this province's FID program.

3. Local: VFIs and Related Institutions

Not much formal coordination between VFIs and other local development agencies exists at the village level. However, it is too early for most VFIs to be part of joint economic development projects. A few stronger BKK have participated in pilot projects to finance hybrid corn production and village electrification. However, the BPD/Central Java would like its supervisors to undergo special training in how to identify and analyze economic development projects before expanding such efforts. We recommend that such training be given to BPD/Central Java supervisors during FY 88-89 and then offered to supervisors in other FID projects in subsequent years.

B. Systems and Procedures for Resource Flows

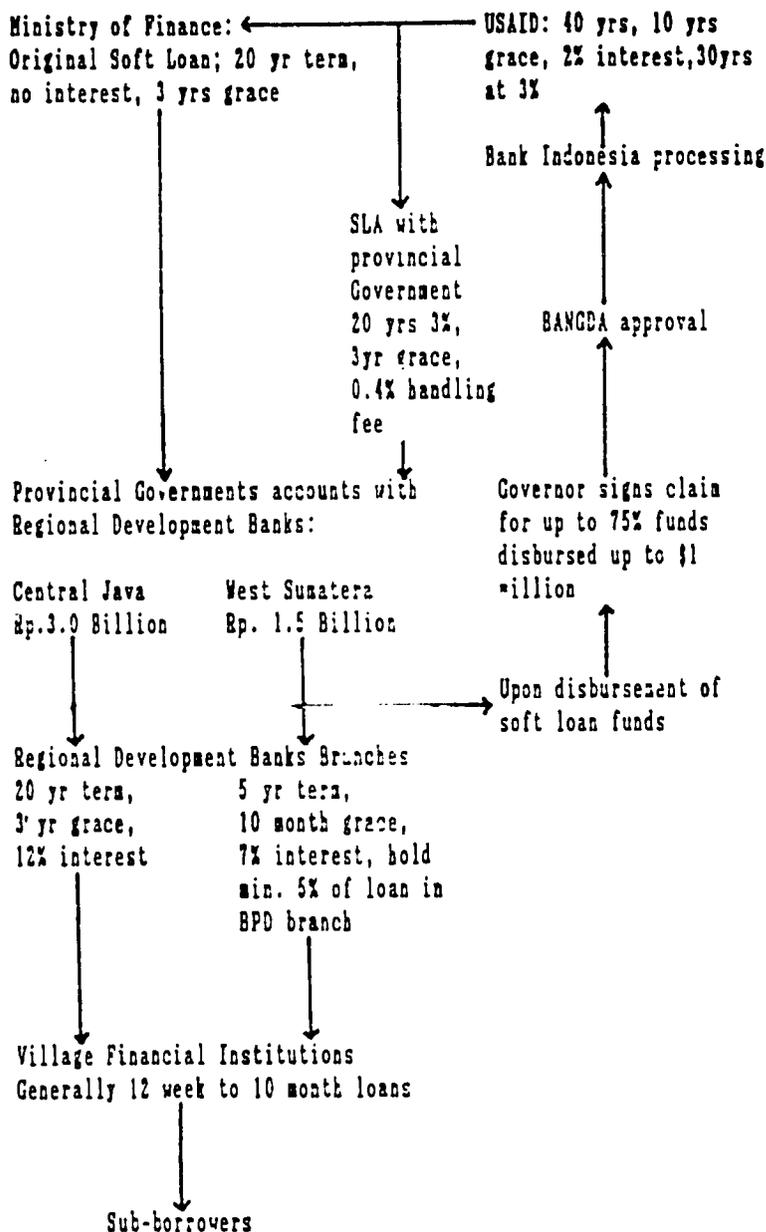
1. Capitalization

The original capitalization process was complicated and presented opportunities for many bottlenecks. This system applied to funds disbursed to Central Java and West Sumatera; under it, USAID reimburses BPD for a percentage of the GOI funds that have been disbursed to VFIs. The project amendment changed this system for West Java and East Java. These two provincial development banks receive funds directly from USAID, irrespective of the GOI contribution.

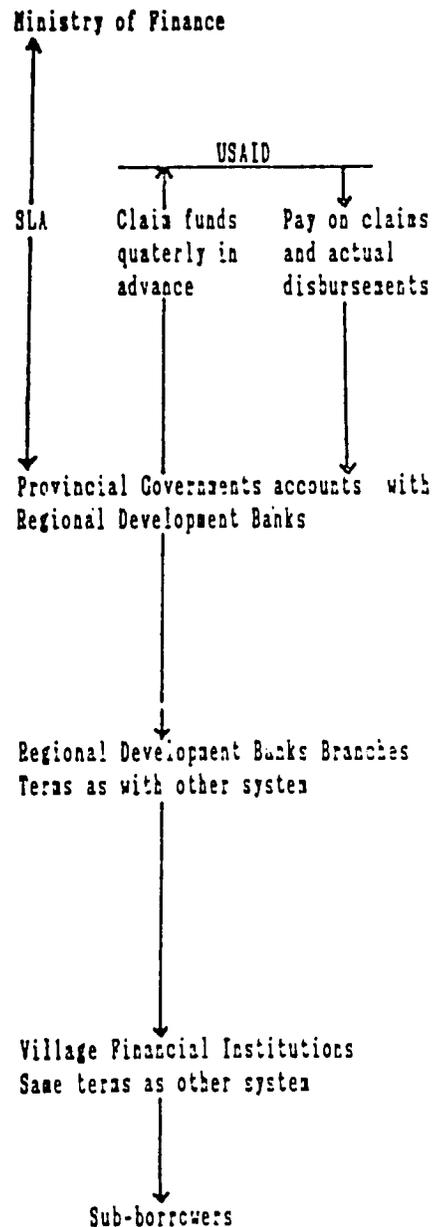
The process for Central Java and West Sumatera and the terms and conditions of loans is depicted in Figure A. The Ministry of Finance disburses capitalization funds to the Regional Development Bank (BPD) in the name of the Provincial government. These funds flow through BPD branches, VFIs and finally to sub-borrowers. The BPD reports the amount of VFI disbursements to the governor who certifies the report and submits the document to BANGDA.

FIGURE A : CAPITALIZATION PROCEDURES

Central Java/West Sumatera



West Java/Bast Java



BANGDA sends this request to Bank Indonesia which, in turn, submits the request to USAID. Seventy-five percent of the funds disbursed by the BPD to VFIs is reimbursed by USAID to the Regional Development Bank.

This amount becomes a subsidiary loan agreement (SLA) between the Ministry of Finance and the Provincial government. Thus, the provincial government has two loans; the first is interest free (soft loan), the second has a three percent annual interest charge (see Figure A). The SLA must be approved by the provincial legislature and the governor, usually a long process. The Central Java and West Sumatera regional development banks are supposed to be reimbursed up to one million dollars in the name of the provincial government.

As of February 1988, the Ministry of Finance had completely disbursed the Rp. 3 billion designated for Central Java. The BPD filed two requests for reimbursement from USAID funds. The first request was paid in May 1987 for a total of Rp. 1.433 billion. The second request, equivalent to US\$ one million minus the first payment at current exchange rates, is now being processed.

West Sumatera has received Rp. 1.5 billion from the Ministry of Finance; this represents full disbursement of designated funds. Rp. 1.256 billion has been disbursed to the LPN as of January 31, 1988. The BPD received Rp. 868 million as reimbursement from USAID.

Terms and Conditions:

Ministry of Finance loan agreement with USAID: 2 percent interest rate during grace period, 3 percent thereafter; 40 year term, 10 years grace.

Soft Loan from the Ministry of Finance (MOF) to BPD/Central Java and West Sumatera: Interest free, 20 year term, 5 year grace.

Subsidiary Loan Agreement between the MOF and BPD: 3 percent annual interest, 20 year term, 3 year grace and .4% handling fee.

Provincial government to BPD : put in BPD account, no fee.

Regional Development Bank head office to VFI:

- Central Java: 12 percent interest per year; 20 year term; 3 year grace;
- West Sumatera: 7 percent per year; 5 year term, 10 months grace; 5 percent minimum balance with BPD.

The capitalization procedures in West Java and East Java are simpler and much less time-consuming. The procedures were changed for West Java because their soft loan from the Ministry of Finance was never disbursed. The loan had been approved but national budget constraints resulting from a drop in oil prices, caused these funds to disappear. Since West Java never received its soft loan and GOI funds are not available for East Java, USAID raised the amount of its loan to US\$ 1.5 million each for West and East Java.

Under this system, the Ministry of Finance lends funds to the Regional Development Bank in the name of the Provincial government via USAID prefinancing. The BPDs each prepare a capitalization plan which must be approved by USAID. This becomes a Project Implementation Letter which earmarks US\$ 1.5 for each province for capitalization. It also, describes the capitalization procedures which are as follows: each quarter the BPD reports on disbursements made during that quarter and requests capitalization funds for the subsequent quarter. This process continues until they use up their \$1.5 million at current exchange rates. These funds are on-lent to the VFIs. The terms and conditions between the BPD and VFIs in West and East Java are yet to be finalized. West Java funds are late because of the delay in meeting the conditions precedent. In later correspondence the capitalization plan was divided into three components: a classification system had to be in place (as a rational system for dividing the capital), the planned capital allocations had to be based on the classification system, and a full-time BPD field supervision system was required to monitor the use of the capital. West Java met all of these conditions in late 1987.

At the same time, the provincial government finalized a SLA with the Ministry of Finance. This agreement for West Java was signed in January 1988.

This is a much simpler system as it takes a lot of preparation to meet the conditions precedent. Once there is a Project Implementation Letter (PIL) and SLA then disbursements are fairly automatic on a quarterly basis. The need for this method was learned from the earlier system which has proved to be rather cumbersome.

Delays in receiving capitalization funds has inhibited the progress of the West Java FID program. Changes in the procedures used to disburse funds should speed the delivery of financial resources thereby enabling other resources -- training, commodities and technical assistance -- to be used more effectively.

2. Commodities: Vehicles and Equipment

The system for commodities is simpler. Each provincial BAPPEDA submits a request to BANGDA for commodities based on consultation with the respective project implementors and resident consultants. BANGDA then sends a request to USAID which is reviewed and, if approved, becomes a PIL. The commodities are procured directly by USAID and disbursed to the respective organizations which do not need to handle a flow of funds. Whether this is a satisfactory system for purchase of the computers needs to be resolved. Three options are possible. The first is for USAID to be in charge of procurement but against this is a problem of lack of staff and specialized computer knowledge. Another option is to have BANGDA send the request to the State Secretariat (SEKNEG) for procurement, and the third option is for the commodities to be procured via an amendment to the technical assistance contract as was done for the procurement of the DAI consultants' computers. The advantage of this latter option is that it brings together the technical assistance for computer programming and system design, software preparation and hardware under one umbrella and will lead to faster implementation of this component.

3. Training Activities and Training Equipment

The system of funds flows have been changed for FY 88-89. Until this time provinces used to prepare an annual workplan but now prepare a three-year plan which lists all the training activities that it would like to implement in the forthcoming FY; this includes a timetable and projected funding needs. Based on this, they prepare a series of project proposals with detailed budgets (DUPs). These proposals are reviewed by a central government team (Tim Pusat) composed of BANGDA, BAPPENAS, Ministry of Finance and USAID. These budgets are revised and then become DIPs: project funding documents. These project documents are divided into two categories: those funded by the GOI and those by USAID. GOI funds are disbursed through BRI to the project implementor. USAID combines the DIPs into a Project Implementation Letter which earmarks funds for training needs. Funds are advanced on a quarterly basis directly to the BPDs.

Problems arose because original planning documents for the first two years of project implementation were overly optimistic about the speed of funds disbursement and the volume of training activities. By the end of December 1987, USAID had committed a total of US \$ 2,190,016 for training activities. Of that, expenditures were actually US \$ 388,587. Outstanding advances totaled 312,193 for a total of funds liquidated and outstanding of US\$ 700,780 -- or only one-third of the total training funds committed to date.

USAID has decided to ask each province to prepare a three-year training plan with a realistic implementation schedule and budget. The old training PILs will be canceled and unused balances transferred to new PILs -- only the difference will be added as new funds. This process will give AID a clearer picture of the needs and absorptive capacity for training of BPDs and VFIs staff. Any excess funds can be reprogrammed for other FID project priorities.

In West Java, Rp. 573 million remained unspent as of December 1987 due to slow approval of budget revisions for the 1985/1986 and 1986/1987 fiscal years. Most of these problems appear to be of a procedural rather than a substantive nature. This seems to indicate a lack of will to resolve issues that have not been a constraint in other FID-assisted provinces. Project managers must re-budget their training needs for the remainder of the project to reflect this surplus and increase the efficiency of internal systems used to disburse funds.

In Central Java, training facilities which are already needed and started two years ago, are not completed, and will not be completed within the next two years unless adequate GOI funds are made available. A budget of Rp. 370 million has been provided to complete the dormitories in 1988/1989. An urgent start is needed on providing classrooms. A budget of Rp. 800 million is needed to complete the facilities. West Sumatera and West Java expect to complete their facilities on schedule within two years.

4. Technical Assistance

The flow of funds for technical assistance follows standard operating procedures. DAI submits monthly vouchers, USAID reviews and reimburses these expenses, and then DAI pays its subcontractors.

C. USAID Projected Budget and Actual Drawdown of Funds

Figures on disbursements to February 2, 1988 are shown in Table 1 below. These cover the first two years of the project or forty percent of its life. Undisbursed funds are US\$ 10.475 million of a total obligation of US\$ 13.75 million. For the technical assistance component, disbursements are in line with project life. Disbursements on training are substantially behind commitments and far below the project obligations. US\$ 2.046 million remains uncommitted. A three year estimate of training needs is now being prepared and when completed will provide a

basis for possible re-allocation of funds. For commodities, disbursements are 93% of commitments and expenditures will be close to reserved funds. Concerning capitalization, the funds authorization for West Java have just been signed and West Java has provided a list for the disbursements to be carried out in four tranches over a twelve month period for each VFI. Remaining capitalization funds for Central Java are due for disbursement. West Sumatera will draw down its remaining balances over the next two years.

TABLE 1
 USAID BUDGET FOR FINANCIAL INSTITUTIONS DEVELOPMENT PROJECT
 PHASE I

LINE ITEM	TOTAL OBLIGATION	COMMITMENTS	DISBURSEMENTS	UNCOMMITTED (%)	UNDISBURSED (%)
1. TECHNICAL ASST	\$ 3,500,000	\$ 2,487,521	\$ 792,518	\$ 1,012,479 (29%)	\$ 2,707,482 (77%)
DAI CONTRACT		2,464,047	783,036		
HARDJONO		23,474	9,482		
2. TRAINING	\$ 3,750,000	\$ 1,703,753	\$ 626,722	\$ 2,046,247 (55%)	\$ 3,123,278 (83%)
WEST SUMATERA		479,861	216,742		
CENTRAL JAVA		678,659	266,412		
WEST JAVA		527,439	129,422		
BANGDA		17,794	14,146		
3. COMMODITIES	\$ 1,250,000	\$ 474,488	\$ 441,432	\$ 775,512 (62%)	\$ 808,568 (65%)
46 JEEPS/9 MINIBUSES		474,488	441,432		
ADDTL VEHICLES		---	---		
COMPUTERS		---	---		
4. CAPITALIZATION	\$ 5,000,000	\$ 3,500,000	\$ 1,397,367	\$ 1,500,000 (30%)	\$ 3,602,633 (72%)
CENTRAL JAVA		1,000,000	871,966		
WEST SUMATERA		1,000,000	525,401		
WEST JAVA		1,500,000	---		
EAST JAVA		---	---		
5. CONTINGENCY	\$ 250,000	\$ 19,183	\$ 16,923	\$ 230,817 (92%)	\$ 233,077 (93%)
WORKSHOPS/ADS		19,183	16,923		
TOTALS	\$ 12,750,000	\$ 8,184,945	\$ 3,274,962	\$ 5,565,055 (40%)	\$ 10,475,038 (76%)

III. Technical Assistance Component

A. Resident Consultants

Three full-time consultants are provided by Development Alternatives, Inc. under a contract won through the competitive bidding process. Central Java, West Java and West Sumatera each have one resident advisor. The chief of party is located in Semarang; he spends half of his time providing assistance to the BPD in supervising the BKK program in Central Java. The balance is spent in Jakarta discussing policy and administrative issues with the GOI and USAID/Jakarta, supervising the two advisors in West Sumatera and West Java and three DAI subcontractors and conducting studies to determine the potential expansion of the project into other provinces.

The chief responsibilities of the technical advisors are:

- o Assistance in revising local accounting policies and procedures;
- o Assistance in supervision and audits;
- o Training program and systems development;
- o Improvement of BPD management information systems;
- o Strengthening and designing credit programs; and
- o Savings program promotion.

According to discussions with BPD senior managers in all three provinces, the effectiveness of advisors is dependent upon:

- o Fluency in the Indonesian language;
- o Knowledge of and ability to work within local customs;
- o Substantive knowledge of rural credit systems; and
- o Ability to transfer knowledge to counterparts and field staff.

This imposes an excessive work and travel schedule on the chief of party (COP). While discussions with BPD senior management indicate that they believe that 50 percent of the current COP's time is sufficient for their needs, the remaining 50 percent is insufficient for chief of party tasks. Central Java management stated that the COP carefully coordinates his

schedule with that of the head of the BKK supervision unit within the BPD. BPD senior management in Central Java praised the assistance received by the chief of party, as did BPD managers in the two other provinces.

BPD senior managers in West Java expressed concern over the poor communication skills of their advisor which they believed had seriously hampered his effectiveness. We recommend that the West Java resident advisor be replaced with someone with greater Indonesian language ability and better understanding of the local context.

BPD managers in West Sumatera appeared to be pleased with the FID resident advisor who had good working relationships at the field level. This advisor has identified key constraints towards improved LPN performance and worked to remove them.

B. DAI Subcontractors

1. Capelle & Tuanakotta

This subcontractor is expected to provide 20 person-months of technical assistance in bookkeeping and administration to the VFIs. In addition, this Indonesian firm is expected to assist the BPD in each province to evaluate, redesign and test local units' accounting systems and related procedures and forms and help the BPD to develop a training program and curriculum for instructing local unit staff in the use of these new systems. The subcontractor is also spending much needed time on teaching auditing and supervision procedures. During February 1988, the firm also provided refresher training to Central Java BPD supervisors and BKK managers in how to include non-cash expenses (depreciation, write-off of bad debts) in the final year adjustments and how fill out their tax return forms. Auditing and supervisory training is to be offered in West Sumatera in April 1988. A standardized manual on accounting procedures is needed especially in West Java to standardize the BKPD and LPK procedures and the subcontractor will participate in this.

The evaluation team observed training offered by Drs. Theodorus M. Tuanakotta on accounting in two BPD coordinating branches - training about 80-100 managers in each one-day course. The training appeared to be very effective and had the practical benefit of enabling the BKK to calculate their taxes correctly. An indication that BPD staff found this training useful is that BPD Central Java have requested Mr. Tuanakotta to provide consultancy assistance to them under a separate contract funded by the BPD for non-BKK departments.

2. P.T. Panca Bina Esa

This subcontractor was hired to provide technical assistance in the training of trainers for BPD and local government staff in the project provinces and for staff of the respective VFIs and their staff. P.T. Panca Bina Esa started activities in West Sumatera but, after criticisms of the subcontractor's performance by the BPD and the FID resident advisor, its contract with DAI was suspended in April 1987. Of a contracted total of Rp. 66,822,303, an amount of Rp. 23,236,907 (35 percent) has been billed and paid. Neither the West Sumatera nor Central Java BPD managers (who had also met the president director of PBE) believed that they needed this type of training. West Sumatera BPD senior management criticized the training materials prepared by this subcontractor as being too theoretical and of little practical use to BPD staff. Given the poor performance of this subcontractor in West Sumatera, the evaluation team recommends terminating this subcontract and re-allocating funds to higher training priorities. Given the extremely positive response to training offered by Capelle & Tuanakotta, project managers should consider whether the role of this subcontractor might be increased.

3. P.T. Central Rama Informatik

The purpose of this subcontract is to prepare software based on BPD-designed management information systems to improve BPD technical supervision of and support to the VFIs in the project area. The subcontractor has programmed a system designed by the BPD and this is being tested currently in Central Java. It is expected this will be completed by early 1988 for adaptation in West Sumatera and West Java. The original programming and revisions required about seven calendar months; P.T. Central Rama Informatik's programmer believes that each additional province will require only three months of programming time. The need to first standardize report formats in the provinces caused delays in the implementation of this project component. It is still premature to evaluate the performance of this subcontractor.

IV. BPD Role and Effectiveness

A. Capitalization

A key role of the BPDs in each province is to act as a financier to VFIs. The amount of capitalization received by a VFI is determined by its class rank. Its ranking is established by using indicators collected on a semi-annual basis in a classification survey. This is a useful system to determine the absorptive capacity, efficiency and financial viability of VFIs. It is strongly recommended that this system be continued in existing FID areas and be introduced in other provinces with similar lending programs. Statistics in the classification survey, however, should be verified by an on-site visit by the BPD supervisors prior to capital disbursement. Capitalization funds can also be used as leverage to ensure that VFIs file reports on time.

A key issue is determining the terms and conditions of BPD loans to VFIs. BPD/Central Java charges one percent per month and is allowed to retain 60 percent of that amount to cover administrative expenses connected with BKK supervision. Of the remaining 40 percent, half is placed in a reserve account against BKK failures while the remainder becomes part of a BKK development fund.

BPD/West Sumatera charges its VFIs seven percent annual interest but is only permitted to retain 35 percent of this amount to cover its administrative costs.

The BPD/West Java has not yet decided upon the terms and conditions of its USAID-funded loans to the BKPD/LPKs. Interest rates currently being discussed are at 12 percent per year.

As shown in the following table, currently all three BPDs' costs of VFI supervision are greater than interest income. Since an important principle of the VFI program is that they be financially viable, we believe strongly that there is no reason why the program should not be financially viable at the level of the BPD. In effect, the BPD's current interest rate structure means that they are subsidizing the VFIs.

The BPD in West Sumatera, in particular, shows a disturbing trend: losses are increasing as the program expands, thereby raising supervision costs. The gap between interest income and supervisory expenses is growing. Since arrears from the VFIs do not appear to be a problem, clearly interest income is inadequate to cover minimum supervision expenses. Either supervision expenses must decline through more efficient use of resources or income to the BPD should be increased by imposing higher interest

rates and shares of interest income. West Sumatera BPD supervisory expenses in 1987 were Rp. 205.8 million and these need to be covered. We recommend that interest rates to LPNs be raised substantially and the percentage of funds currently retained by the BPD be raised also. Similarly, BPD/West Java should set its interest rates so that it can, at a minimum, cover its costs at the volume of lending that is expected to be generated by the infusion of capitalization funding.

The BPD/Central Java has been concentrating its efforts on reducing losses from supervising the BKK. Its senior management hopes that as disbursements increase due to the onlending of USAID funds, interest income will be sufficient to cover administrative expenses.

TABLE 2

PROFITABILITY OF THE VFI PROGRAM TO RESPECTIVE BPDS

Total BPD Village Financial Unit Operational Income Less
Total BPD Village Financial Unit Operational Expenses

(in millions of rupiah)

	July 1985 to December 1985	July 1986 to December 1986	January to June 1987
BPD/Central Java	-53.7	-51.3	-48.2
BPD/West Sumatera	N.A.	-35.8	-56.7
BPD/West Java (LPK)	-35.5	-40.6	-58.0

B. Commodities

Vehicles used by the BPD in all three provinces seem dedicated to serving the VFI supervision needs. Central Government is now processing requests for supplementary vehicles for Central Java, West Java and West Sumatera in keeping with project needs. The proposal to equip Central Java, West Sumatera, West Java and East Java BPDs with computers at the head office and in Central Java at the coordinating branches has now

been incorporated in a Project Implementation Letter. This will also provide BANGDA with four personal computers to help process FID project information as well as that on other projects. Current proposals for computerization are relevant to project needs.

C. Management Information System

Following a system review for rationalization and automation, the BPDs, with the assistance of DAI and the subcontractor, are now upgrading the management information system using the four basic report inputs of: monthly progress report, quarterly balance sheet and profit and loss statement, and the six monthly classification survey. It is anticipated that this will provide at least sixteen specific and relevant reports for managerial use.

West Java and West Sumatera have lagged behind in the collection of indicators compiled from these reports. Baseline performance indicators were collected during the first year of project implementation; another six months were required to complete, verify and update these indicators. This has, as previously mentioned, delayed the computerization of the information system. Spot checks reveal that the quality of indicators from VFIs in West Java and West Sumatera is uneven. Because different VFIs are included in West Sumatera's classification reports each six months, some failing to report, some dying and new institutions entering the system, it is difficult to compare performance over time. In West Java also, the numbers of LPKs and EKPDs are increasing with each collection of data. It is strongly recommended that the BPD West Sumatera be more stringent in LPN reporting requirements and carefully analyze data for discrepancies.

D. Change in BPD Auditing, Inspection and Supervision

BPD supervision of the VFIs varies among provinces. In Central Java field supervisors visit their BKK at least once each month. In addition, Central Java has formed a four-person troubleshooting team whose responsibilities include checking on the BPD supervisors as well as handling more difficult problems encountered by the BKK. This team has received special training, and will in turn adopt a high profile in future training of BPD and BKK staff. This concept of a troubleshooting team appears worthy of duplication in other provinces.

Visits made by supervisors in West Sumatera are less regular. Since most LPNs are open only twice a month, and often on the same day, it is not possible for the field supervisor to visit many more than half of the sixteen LPNs he is expected to

visit on a monthly basis. In 1987, a great deal of field supervisors' time was spent reviving 65 LPN units and creating 17 new LPNs. During that period, however, the number of Class V units increased from 47 to 129 and the number of Class I,II and III units declined from 152 to 78. Only about 130 of the 586 LPNs are actually operating (Class I-IV).

It is unclear how much of the decrease is due to more accurate data but in any case, rather than dedicate resources to resuscitate dead units, we recommend that the priority be placed upon improving the position of Class I-IV LPNs. Only after these units are in good operating condition should supervisors spend their scarce time on reviving dead units. Given the importance of cost-effective supervision, we recommend that focus be placed upon the stronger units. Nagari units would serve as weekly posts of a stronger, larger kecamatan level coordinating unit. Nagari units should retain their local managers and cashiers; however, the bookkeeping function would be performed by a professional staff member of a kecamatan level coordinating unit. While BPD supervisors would make spot check visits to these Nagari-level posts, most of their supervision time would be spent at the kecamatan unit.

In West Java, the BPD supervisors are expected to start visiting the BKPDs on a more regular basis following their drawdown of FID capital. Supervisors visits LPK and BKPD units on a quarterly and semiannual basis, respectively. This schedule is inadequate to meet the supervision needs of village financial units. Each VFI should be visited at least once per month. BPD supervisors should prepare a work plan every month which specifies which VFIs will be visited; this should be monitored by the BPD branch manager and used as a basis to evaluate the supervisor's performance.

E. Local Training Program

1. BPD Staff

Training of BPD and VFI staff is critical to achieving project objectives. BPD staff in all provinces require on-going training in VFI supervision techniques, auditing, bookkeeping, mobilization of savings, funds management and other issues of particular relevance to each province. As shown in Table 3 below, training of BPD staff in West Sumatera and West Java is behind schedule. (Statistics for 1987-1988 cover only nine months through December 1987).

The BPD in Central Java had a strong commitment to training even before the FID project began. The need to prepare correct tax forms for the BKK only increased the BPD's will to conduct

practical training courses. BPD/Central Java supervisors have received training in basic areas listed above as well as the treatment of non-cash transactions, loan write-offs and the preparation of BKK tax forms. Some of the training received by BPD supervisors uses the case study method, with actual examples for the BKK program. Outside observers are discouraged from attending these sessions so as to encourage BPD supervisors to exchange ideas and speak freely. This type of training appears to be extremely effective and should be replicated in other provinces. BPD/Central Java staff would like BPD staff to receive additional training in the preparation of training materials, financial analysis of BKK data, computerization, assessing the market for BKK development, savings mobilization and the identification and analysis of economic development projects.

Although West Sumatera has not, to date, met its training targets, training of BPD staff was greater than originally anticipated in 1987. This included instruction in field supervision, auditing, technical assistance and treatment of non-cash transactions. In addition, five staff members were sent to Bogor for training in communication skills.

Specialized training of BPD/West Java LPK/BKPD supervisors by Cappelle & Tuanakotta has not yet begun. This type of training plus repeat courses in field supervision techniques is urgently needed and should be a priority for FY 1988-89. Field supervisors observed in the field appeared to lack basic supervisory skills. For this reason, we recommend that USAID require that progress towards meeting training targets be demonstrated as a precondition to the disbursement of capitalization funds to West Java.

TABLE 3

NUMBERS OF PEOPLE TRAINED BY LOCATION AND ORGANIZATION

	1986-1987		1987-1988	
	Target	Actual	Target	Actual
BPD staff:				
West Sumatera	30	11	19	26
West Java	136	122		
Central Java	40	70	40	73
VFI Staff:				
West Sumatera	600	333	420	205
West Java	710	338	530	298
Central Java	800	1164	320	630
VFI Oversight Boards and local government				
West Java	400	400		
Central Java	80	200	80	249

2. VFI Staff

For 1986-1987, actual numbers trained in West Java and West Sumatra were less than targets due to delays in funding, BPD staff availability and in the preparation of training materials. For each category, Central Java has exceeded targets and this reflects the commitment to training in the province.

VFI staff have been trained in bookkeeping, credit procedures and loan appraisal. All key staff have received some training and need constant follow-up and reinforcement through classroom and on-the-job training from field supervisors.

In Central Java, the second round of training of BKK managers began in February 1988. In addition, follow-up training was provided in the recording and use of non-cash transactions to enable BKK managers to calculate their units' taxation liabilities. This training was led by Capelle & Tuanakotta with support from BPD supervisors who had previously undergone the same training. It appears to be extremely useful in sharpening BPD staff supervisory and training skills. All 497 BKK managers underwent these one day training courses. In the process of this training, individual skill deficiencies of staff were identified and corrected immediately.

Training in auditing methods is scheduled next for West Sumatera in February. The BPD in West Java had not formally requested such training as of February 1988. We strongly urge that BPD/West Java VFI staff participate in intensive training courses. In the VFIs visited by the team, serious deficiencies in the bookkeeping, accounting and procedural systems were observed. BPD supervisors must increase their knowledge of audit procedures and VFI operations to become effective trainers of VFI staff.

An orientation workshop for Badan Pembina staff, Sub-district Heads, secretaries of the Districts, and people from the Provincial Legislature has already been held in Central Java. This will be repeated for officials at the village level. This program also needs to be extended to cover the other project provinces.

F. Study Tours

1. Tours Within Indonesia

BPD/Central Java staff visited similar programs in West Sumatera and Bali. Senior management state that they found these visits to be very helpful. Specifically, some of the voluntary savings practices found in these provinces were incorporated in the BKK voluntary savings pilot project. BPD/West Sumatera also visited the LPD program in Bali and incorporated the practice of house-to-house savings collections and encouraging school children to save at the local LPN. In addition, BPD staff visited seven sites within West Sumatera; this involved taking the managers of weak LPNs to visit strong ones. Six additional study tour sites in West Sumatera have been approved for early 1988.

BPD/West Java staff visited Central and East Java as well as the program in West Sumatera. As a learning device, all participants interviewed found the study tours to be very useful.

2. Foreign Study Tours

It is recommended that the countries to be visited on the foreign study tours be carefully chosen so as to be culturally similar to Indonesia and also demonstrate ways to resolve problems common to Indonesian rural credit projects. Examples of successful projects servicing microenterprises in urban areas and those with successful funds mobilization methods might also be visited. Besides visiting the Grameen Bank in Bangladesh, other examples might also be found in Southern India or East Asia.

V. VFI Administrative and Financial Performance

A. Bookkeeping and Reporting Systems

Further refinement of VFI bookkeeping and reporting systems and procedures are still needed. Systems are weaker in West Sumatera and West Java than in Central Java. These two provinces have no system or standardized method to handle non-cash transactions such as depreciation, accrued interest on savings and loans, provisions for doubtful debts and loan write-offs. The method of reporting delinquencies is not satisfactory: rescheduled loans are commonly reentered as new loans instead of remaining in arrears. In addition, the aging of arrears needs to be systematized, and the calculation and posting of penalty interest needs clarification. The VFIs in West Java and West Sumatera do not have province-wide standardization of interest rates in terms of percentages and method of calculation.

West Java urgently needs to finalize the operations manual for the BKPDS and LPKs and then ensure its use through a series of training courses. The current draft needs to be improved in its completeness and simplified by taking out redundancies and unnecessary data requirements. The assistance of the subcontractor, Capelle & Tuanakotta, is recommended for this and for the training leadership.

B. Personnel Issues

Central Java has made substantial progress in replacing civil servants with full-time BKK professional staff. During 1985-1987 the number of civil servants working at the BKK declined from over 500 to about 150 -- or about 8 percent of total staff. This improves the control and influence of the BPD over BKK staff performance and facilitates the removal of incompetent managers.

In West Sumatera, the LPN manager and staff are appointed by its members. This makes it more difficult to ensure that a satisfactory level of management is maintained. The BPD has had mixed success in requiring LPNs to report to it even though the units have received soft loans from the BPD. The effectiveness of training of LPN staff has been hampered since many staff left for new jobs after completing their training course. To overcome a similar problem in West Java the governor has decreed that government officials must remain in their positions for at least two years after receiving training. This should help to alleviate this problem. Support from the local government is needed to improve the quality of VFI management.

Many of the LPKs in West Java are staffed by local government civil servants and these are supervised by very active local government inspectors. However the salary cost of these civil servants is not included in the expenses of the LPKs. To determine the sustainability of operations the costs of all staff should be included in operating expenses.

C. Efficiency and Effectiveness of Performance Indicators

Each quarter DAI reports on progress towards achieving the annual work plan; each six months a report covering the financial indicators for the VFIs and their classification groupings is prepared. These indicators represent a complete system of monitoring key performance variables but the true efficiency and profitability of each province's VFI lending activities will not be known until old loans are written off and rescheduling of loans is done correctly. In particular these deficiencies overstate the reporting of net profits and net worth, the real asset value of loans outstanding, and the real turnover, or circulation, of lending and number of active customers.

1. Review of Quarterly/Semi-Annual Indicators: December 1985-June 1987

a. Volume of Lending and Savings

In the following tables it can be seen that the FID VFIs, on average, enjoyed a significant increase in the volume of their activities during the eighteen months covered by the financial indicators. The most rapid growth in lending has been in the BKPDs at the rate of 44% per year followed by the others at between 25% to 28%. Overall, the rate of increase in number of borrowers is 8% per year.

TABLE 4

NUMBER OF BORROWERS

	December 1985	December 1986	June 1987
West Sumatera: LPN	11,719	14,126	14,041
West Java : LPK	19,088	18,943	22,681
BKPD	56,869	61,044	65,001
Central Java : BKK	448,960	482,626	500,863
Total :	536,636	582,739	602,586

Table 5 shows that the average loan size is becoming larger especially in West Sumatera and West Java. Within the BKKs average loan size was Rp.52,000 in December 1985 and Rp. 56,000 in June 1987. Comparative figures for the same time period in West Java are Rp. 117,000 and Rp. 127,000 for the LPKs and Rp. 163,000 and Rp. 200,000 for the BKPDs. In West Sumatera average loans outstanding per borrower have increased from Rp. 131,000 to become Rp. 158,000 over the same time period. In West Java, the proportion of borrowers receiving loans of Rp. 50,000 or less has declined from 60% of the total in 1985 to 36% in June 1987. In West Sumatera the share of loans outstanding for loans of less than Rp. 50,000 has declined from 13% in 1985 to only 5% by June 1987. These trends are disturbing as they indicate that some of the VFIs are not focusing their loan activities on the economically weaker section of society and are starting to compete, in loan size, against the BRI Unit Desas which have a cheaper loan interest rate.

As with loan volumes, there have also been increases in the average monthly loan circulation figures. In Central Java there has been an increase in the circulation figures in relation to loans outstanding and this indicates a faster, and desirable, turnover of loan funds. Within the BKPD this ratio has deteriorated while it has remained unchanged for the LPKs. This indicates a need to make better use of assets in these two VFIs. No data is available from West Sumatera.

There has been a trend towards increasing the use of savings as a source of funds for lending activities as can be seen in Table 6. However, in the case of West Sumatera and West Java this is mainly in the form of forced savings that are, except in extraordinary circumstances, not available for withdrawal by depositors. The relative decline in savings as a percentage of loans outstanding in Central Java has been due to instituting a new policy which allows loan recipients to withdraw forced savings once their loan has been repaid. This decline will be offset by the expansion of the TAMADES voluntary savings program.

TABLE 5

KEY FINANCIAL INDICATORS OF FID VFI PERFORMANCE:
DECEMBER 1985, DECEMBER 1986 AND JUNE 1987

(all figures in billions of rupiah except average loan size)

	Average Monthly Circula- tion	Loans Out- standing	Average Loan Size	Savings & Deposits	Net Profits (6 mos.)	Net Worth
<u>BKK</u>						
Dec 1985	2.3	11.9	52,000	2.1	1.0	6.2
Dec 1986	2.8	15.1	57,000	2.5	1.2	8.0
June 1987	2.9	16.7	60,000	2.4	1.2	10.1
<u>LPN</u>						
Dec 1985	NA	1.5	NA	0.6	0.1	0.3
Dec 1986	NA	2.0	NA	0.8	0.2	0.3
June 1987	NA	2.2	NA	1.1	0.2	0.3
<u>BKPD</u>						
Dec 1985	0.4	4.9	163,000	0.6	0.2	0.6
Dec 1986	1.3	6.8	252,000	1.8	0.5	1.5
June 1987	1.2	8.5	200,000	1.9	0.4	1.2
<u>LPK</u>						
Dec 1985	0.2	1.1	112,000	0.2	0.0	0.2
Dec 1986	0.3	1.5	120,000	0.3	0.1	0.3
June 1987	0.3	1.7	127,000	0.4	0.1	0.4

TABLE 6

TOTAL SAVINGS & SAVINGS AS PERCENTAGE OF LOANS OUTSTANDING

	Savings Dec.1985	% of Loans	Savings Dec.1986	% of Loans	Savings June 1987	% of Loans
West Sumatera	647	42%	800	40%	1,055	48%
West Java: LPK	224	20%	323	22%	354	22%
: BKPD	589	12%	1,788	26%	1,865	22%
Central Java	2,157	18%	2,447	19%	2,389	14%
	3,617		5,358		5,663	

b. Lending Quality

The quality of the VFIs' loan portfolio appears to have deteriorated slightly as shown in table 7. This may be explained by a steady improvement in the recording of delinquent loans rather than actual increases in the amount of delinquent loans.

TABLE 7

VFI LOAN PORTFOLIO QUALITY
(Cumulative figures)

	---December 1985---		-----June 1987-----	
	Current Loans	Delinquent Loans	Current Loans	Delinquent Loans
	(percentage of outstanding loans)			
West Sumatera	81	19	73	27
West Java: LPK	61	39	58	42
: BKPD	74	26	71	29
Central Java	84	16	82	18

Delinquent loans are divided into two categories: those where repayments are overdue within the original term of the loan, and those with delinquent repayments due after the loan term has expired. Bad debts, defined as more than six months beyond loan repayment date, currently vary between 8% to 23% of the loans outstanding for the two provinces that are yet to start a system of provision for doubtful loans (West Sumatera and West Java). Once old bad debts are written off, repayment rate and portfolio quality statistics will improve, at least in the short-run but net profits and assets will decrease.

The reliability of some of the indicators is uncertain. Besides problems created by the inexact measure of irrecoverable loans in the region, there is a changing number and mix of VFIs being recorded in West Sumatera and West Java. As a result, net worth figures are not consistent with the accumulation of net profit data. For example, in West Sumatera, consolidated net worth decreased during January-June 1987 while net profits increased. Another problem is that West Sumatera VFIs do not record the number of borrowers receiving new loans with the result that loan circulation data, average loan per borrower and operational expenses per loan are not available. In the LPNs visited it could be seen that the data is available but needs to be analyzed further.

Interest incomes declared by the four groups of VFIs are substantially less than the effective interest rates. Depending on the type of loan and whether the rates are flat or in declining balances, the effective rates are between 58% and 90% per year. Interest income as a percentage of loan however is about 27% to 34% on average. Some of this difference is explained by low loan turnover. Central Java, for example, based on a 12 week loan theoretically could reach a loan turnover of over four times. However, BKK reduce outstanding loans before and during Lebaran to prevent loans from being used for unproductive purposes and to prepare for large savings withdrawals. Thus, actual loan turnover is closer to three times.

Another reason to explain the discrepancy between actual income and effective interest rates is that the latter decline substantially when borrowers are not penalized when they do not make repayments on time. Missing all payments until the last payment is due, for example, reduces the effective interest rate by more than half. This would seem to be a major explanation for the comparatively low interest income figures for the VFIs. This suggests that the VFIs should introduce a reward system to encourage prompt repayment of loans so that good borrowers do not effectively subsidize slow payers. Central Java is planning to introduce such rewards during the FY 1988-89.

Another cause, mentioned earlier, is the existence of non-earning bad loans which are pulling down circulation figures and interest income on loans outstanding. These problems need to be resolved individually within each VFI and province and only then can the true quality of the loan portfolio be discerned.

2. Cost of Financial Intermediation

Until there is there is a complete and adequate provision for doubtful debts the costs of financial intermediation represent only administrative costs and costs of funds. With a large use of compulsory savings and/or the use of internally generated funds for asset growth, the cost of funds has generally been less than 2% of total assets. This is expected to increase as savings programs are promoted and interest is paid on a larger proportion of savings. VFIs with low profit margins and heavily reliant on externally supplied funds will face rapidly rising costs of funds; coupled with bad loan write-offs these factors will put some VFIs into a tight position.

Total operational expenses per loan for the BKK, LPK and BKPD are Rp. 3,700, Rp. 15,114 and Rp. 20,806 respectively and as percentages of average value of loan granted are 6.5%, 14% and 10.4%. Translated into percentages of loans outstanding these figures become 12%, 19.5% and 16%. It is estimated that costs of funds are generally similar to the Central Java figure of 2% on loans outstanding.

D. Sustainability

1. Growth, Coverage, Market Saturation

a. Growth

The growth of lending under the FID program has been financed through the provision of soft loans to the VFIs, compulsory savings from borrowers, the internal generation of income and, more recently, voluntary savings. Some fully capitalized VFIs are now receiving commercial loans through their BPDs. In West Sumatera loan growth exceeds that of income growth and the LPNs are increasing their liabilities as a percentage of net worth. This is not sustainable in the long term. Net profits need to be increased through improvements in the quality of lending. Attention needs to be directed also to the effective interest rates charged on loans which, at 58% to 74%, in two of the provinces, may be too low to cover full operational costs.

The effective interest rates in Central Java have maintained an asset:liability structure that can sustain the growth in lending. In West Java, where the interest rates are similar to West Sumatera but soft loan capitalization is yet to be realized, doubts on the sustainability of lending remain.

b. Coverage

In West Sumatera and Central Java there is at least one registered VFI for each sub-district. Beyond this level there is considerable variation between the provinces. West Sumatera has 100 Sub-districts and 741 villages compared with 105 class I - IV LPNs. The average number of borrowers per unit is only 121 against 126 in December 1985. The project financial indicators report a coverage figure, generally the number of villages serviced directly by the VFI, of 16% of villages while the BPD data, which assumes all LPN are active and cover all villages in their area, reports 82% coverage. Total number of LPNs is 586 of which 234 are in the class I - V categories. With the ongoing shifts between categories and the ongoing rehabilitation and creation of new units it is difficult to determine the exact coverage of the whole region. This state of flux is not sustainable. It is necessary to rationalize the numbers and locations of the LPNs in a more systematic manner and unless this is done very soon the FID program in the province will be adversely affected. Table 8 summarizes the positions in the provinces.

TABLE 8

CLASSIFICATION OF VFIS IN CENTRAL JAVA, WEST SUMATERA AND WEST JAVA

	CENTRAL JAVA		WEST SUMATERA		WEST JAVA	
	Dec. 85	June 87	Dec. 86	June 87	June 87 BKPD	June 87 LPK
CLASS I	113	133	34	16	68	22
CLASS II	129	149	48	20	44	27
CLASS III	134	118	70	42	48	20
CLASS IV	40	38	22	27	33	46
CLASS V	80	59	47	129	31	31
DEAD			358	352		
TOTAL	496	497	579	586	224	146

West Java has 308 active LPKs and BKPDs in 439 sub-districts. Many of the sub-districts that are not yet covered have small population sizes that do not warrant the creation of a full-sized LPK unit. Attention needs to be directed to the creation of a village post system that is compatible with small numbers of potential borrowers and low administrative costs. Average numbers of borrowers per unit are 197 for the LPKs and 337 for the BKPDs. Comparative numbers in December 1985 were 201 and 289 respectively. Except for a few pilot projects, there are no activities at the village level, so the percentage of villages covered shows as zero in the financial indicators.

Central Java has 497 BKK units (one per sub-district) complemented with 2860 village posts to provide a coverage of 34% of all villages. The number of village posts has increased by 394 since December 1985. This growth and position is sustainable as profits continue to grow in the region. The average number of borrowers per BKK unit is 1007 and this has increased from 903 in December 1985.

In West Sumatera and East Java there is a need to coordinate and consolidate units at the subdistrict level and use these as the umbrella under which a village post system can grow.

c. Market Saturation

Demand for loans is high in all provinces. In West Sumatera, where internally generated funds are insufficient to meet local demand, borrowers often receive loans that are less than the amount requested. The growth in lending under the program has not shown any indication of slackening. Annual growth rates of 25% to 29% in FID-assisted provinces can be compared with the growths of 16% to 47% for the BRI Unit Desa lending in the same provinces and 18% to 19% for the Bank Desa and Lumbung Desa in Central and West Java.

Village credit coverage under FID is between 16% and 34% of all villages. This indicates that there is still a large market for FID operations provided that posts are not located in villages solely reliant on agricultural activities whose income flows are too vulnerable to climate and disease factors.

Under the new TAMADES savings program launched in Central Java it has been observed that about 75% of the savers are not yet borrowers from the BKKs. This shows that there is still a large market for small lending in the area.

2. The Ability to Mobilize Savings and Borrowings from Other Institutions

This depends upon the VFI's ability to utilize funds profitably. Based on the financial indicators for the 12 months ending June 1987, net profits as a percentage of average loans outstanding were: 15.8% for the BKKs, 13.7% for the LPNs, 11.6% for the BKPDs and 10.5% for the LPKs. This takes into account the VFIs' average cost of funds expense which was about two percent of loans outstanding.

These profitability percentages, of course, grow smaller when calculated on average total assets. This calculation is necessary because cash assets will need to be increased as a reserve against voluntary savings, thereby lowering the percentage of loans outstanding/total assets to below 90 percent. This means that income-earning assets will decline as a percentage of total assets, causing net profits as a percentage of total assets to decline. Furthermore, net profits to total assets will decline once provisions for doubtful loans are included as an expense.

After these adjustments are made, neither the West Sumatera nor West Java VFI, in general, have a profit figure that is at least equal to the marginal cost of raising capital at market rates (15 to 18 percent). After bad debt write-offs and a continuing increase in efficiency, many of the BKK units will be able to sustain operations utilizing commercial funds flows. The VFI systems in the other provinces have yet to reach this level.

3. Sound Legal and Organizational Status of VFIs

All the VFIs have now advanced beyond project status and have now been constituted as legal entities by their respective local government legislatures. The enactments also cover matters such as organizational structure and distribution of profits.

Since many of these units are now accepting voluntary savings in advance of receipt of permission from the Ministry of Finance the question of the extent of liability for full repayment of such savings needs to be resolved.

In Central Java, the acceptance by the BKKs of their taxation liabilities further strengthens their position as full legal entities. Unfortunately they are now being asked to pay tax in monthly installments which will be a severe strain on their administrative capabilities.

4. Responsiveness to Local Needs

In Central Java, the increase in number of village posts, the introduction of the TAMADES savings program, permission for class I units to lend up to Rp. 1 million to a borrower, the introduction of longer lending terms and the introduction of a rebate system for prompt loan repayment, are all indicators of the ability of the BKK to respond to local markets. This is not seen in the other provinces where a viable village post system is yet to emerge and the number of small borrowers, and probably new borrowers, shows little sign of increase. West Sumatera and West Java are providing a voluntary savings service but it is necessary to ensure that this supply of funds is being directed towards smaller borrowers. In the units visited the impression gained was of existing borrowers receiving larger loans.

5. Integration with Financial System

At this stage of the project, and apart from the soft loan capitalization funds flowing from the BPDs to the VFIs, there is very little interaction between the VFIs themselves and between the VFIs and their respective BPD branches. BKKs with cash balances of more than Rp. 300,000 are required to deposit the excess with their local BPD branch. Interest is paid on this.

For a very large number of rural inhabitants, the FID VFIs represent an introduction to a formal financial institution and allows them scope for financial progress either as savers or borrowers. The BPDs also view the VFIs as a source of potential customers as they prove their ability to develop activities and their demand for financial assets grows.

VI. Future Strategy

A. Expansion of FID program

The experience derived from FID implementation is an important source of information to formulate national rural credit policies and standards. The FID strategy may be adapted and used to develop village financial institutions, in the long-term, throughout Indonesia.

The objective of establishing village financial institutions that provide credit for productive purposes, collect voluntary savings and are financially viable responds to an important need in rural areas of Indonesia. Lessons learned from the experience of the FID project in three provinces indicate that certain factors play a large role in determining the relative success of VFIs. These include:

- o Strong support at the highest provincial government levels;
- o Good capacity of the provincial BPD to supervise VFIs;
- o Services at the village level to reduce transaction costs to customers, and administration and supervision activities at the kecamatan level to optimize economies of scale;
- o Separation of ownership from management of VFIs so that VFIs may be professionally managed, although locally-owned;
- o VFI adherence to standard operating systems and procedures which are adapted to local conditions;
- o Use of local peer group pressure and cultural mores to enforce repayment of loans;
- o Setting of interest rates sufficient to allow for the accumulation and attraction of funds; and
- o Capacity to identify and respond to market opportunities.

Certain provinces meet these conditions better than others. We suggest that a five-year plan be developed to examine the potential of expanding FID project components to other regions of Indonesia. The termination of USAID funding of the Provincial Development Project in June 1988 results in a loss of technical assistance to local credit institutions in East Java, West Nusa Tenggara, Bengkulu and South Kalimantan. East Java has already

been added to the FID project; other areas should be evaluated to determine whether they might also be picked up by FID. The first criteria to cull prospective areas is to concentrate upon those with strong BPDs.

The evaluation team examined the appropriateness of expanding the program to Bali. The governor of Bali sent a letter requesting FID assistance prior to the evaluation team's arrival. Senior officials at BANGDA would like Bali to be added to the FID project within the 1988-89 fiscal year.

The team spent two working days in Bali, holding discussions with the governor, the head of BAPPEDA, the chief of the economic bureau of SETWILDA and BPD senior management and VFI supervisors. We visited four VFIs (Lembaga Perkreditan Desa, LPDs) that were representative of the 138 units that had been established as of February 1988. The team spent about two hours at each LPD, meeting with its members and examining its financial records and reports. At the conclusion, a formal meeting to discuss outstanding issues was held between team members and head office and branch-level BPD staff and provincial and district-level BAPPEDA and other government officials.

Considerable progress has been made by the LPD program since its inception in 1985. Each LPD received a soft loan of Rp. 2 million (zero interest, five years grace, ten-year loan term) from the provincial government. Outstanding loans increased from Rp. 58 to 1160 million between 1985 and 1987 year-end. Table 9 presents a consolidated balance sheet of the LPN program and some key indicators of the project's performance.

TABLE 9

CONSOLIDATED BALANCE SHEET OF 98 LPDS IN BALI,
DECEMBER 31, 1987

ASSETS		LIABILITIES	
Cash	68.4	Voluntary Savings	614.7
Bank Deposits	43.9	Term Deposits	216.6
Loans Outstanding	1162.8	Other Liabilities	8.1
Equipment	38.1	Loans Received	43.2
Other	14.2	Capital	263.7
		Reserves	16.2
		Current Net Profit	164.9
Total	1327.4	Total	1327.4

Voluntary Savings + Term Deposits/ Loans Outstanding	71.49%
Total Revenues/ Average Loans Outstanding	41.86%
Net Profits/ Average Loans Outstanding	22.44%

Savings -- both voluntary and term deposits -- comprise over 70 percent of loans outstanding. This reflects the strong community support for the VFI as well as lack of alternative funding sources. Given the high rates paid on voluntary savings and term deposits (1 percent/month and 18 percent/year, respectively), and the relatively low lending rates charged by some VFIs, the margin for bad debts is dangerously slim. Net profits as a percentage of average loans outstanding was a healthy 22 percent overall, but this figure should be treated with caution since the LPD do not constitute provisions for bad debts.

Of the four units visited, each had high participation from traditional village unit members. Unlike West Sumatera which had some VFIs with high membership fees, thereby excluding poorer village residents, each village member in Bali automatically was a member of the VFI. About 36 to 42 percent of village families had received loans through these four VFIs. This reflects a high coverage ratio but also may indicate the low potential for future growth. Traditional village leaders served as part-time VFI managers.

However, the program does reveal some danger signals which, if not corrected during these early years, may seriously affect the financial viability of the program. Problems can be expected to increase as loans become due and the program expands. These problems include a lack of:

- o BPD staff trained and qualified to supervise VFIs;
- o BPD vehicles and other equipment to supervise VFIs adequately;
- o A classification survey and key performance indicators such as loan collection statistics;
- o Regular reporting by VFIs to the BPD;
- o Trained, professional managers for VFIs;

- o Standardized systems, procedures and bookkeeping methods among VFIs;
- o Systems and procedures to deal with delinquent loans;
- o Consistent loan repayment terms and conditions among visited VFIs;
- o Adequate retained earnings to promote growth;
- o Provincial government or other guarantee for voluntary savings; and
- o Basic equipment such as filing cabinets, safes, typewriters and calculators.

Currently, the local government wishes to establish 1320 village financial institutions - one per traditional village. This plan would greatly increase supervision costs for the BPD and, most likely, result in a situation similar to that in West Sumatera. Given that administrative expenses already are a relatively high share of outstanding loans, it might be wise to consider establishing a coordinating unit within Bali's 51 kecamatans. These units would contain bookkeepers that could be shared among several VFI, thereby lowering their costs.

The LPD program is at a critical time in its development. With training provided to BPD and LPD staff, the adoption of cost-effective supervision techniques, the institution of appropriate systems and procedures, and additional capitalization for strong units, this program has a high probability of becoming extremely successful. Without these inputs, the longer-term financial viability of LPDs is questionable.

The LPD program represents a unique opportunity for GOI and USAID support. It has generated a great deal of enthusiasm from provincial government authorities as well as village members. Technical assistance is actively sought and greatly needed. The evaluation team, thus, strongly suggests that the GOI and USAID provide the following support to the LPD program:

- o Capitalization funds for onlending from the BPD to LPDs;
- o Intensive training of BPD supervision staff and LPD management and staff as well as orientation seminars to explain the program to local government officials and traditional village leaders;
- o A resident advisor to help train BPD staff in implementing the above activities; and
- o Basic equipment for LPD offices.

Given the time lag that can be expected before such assistance is provided, assuming that USAID concurs, the team strongly advises that USAID/Jakarta use other contracting mechanisms to provide short-term technical assistance to the Bali LPD program before mid-1988.

B. Organizational and Administrative Options for the Technical Assistance Component

The addition of East Java under the FID project will increase the administrative and supervisory burden of the Chief of Party. Because the KURK program has expanded quickly and has over one thousand units, it is expected to absorb a great deal of planning time. Since the demands of the West Java and West Sumatera programs on the Chief of Party's time are not expected to decline, the addition of East Java would force the COP to spend less time in Semarang and impose an untenable travel schedule. For this reason, the evaluation team recommends changing the structure of project management as follows:

- o The FID Chief of party would be located in Jakarta. His prime responsibilities would be to supervise and monitor activities in FID-assisted provinces, visit other provinces to analyze the potential of including them within the FID umbrella, confer with GOI and USAID/Jakarta officials on project policy and implementation issues. This action should help to ease the administrative burden on USAID;
- o A full-time advisor would be posted to Semarang. While BPD management indicated that it was satisfied with receiving only half-time assistance from the FID Chief of Party, it was made clear that if this individual were to leave, they would prefer a full-time advisor. This individual would be needed to help in the expansion of the savings program from 9 to 400 Class I-III BKK units, provide advice on reviving urban BKK, assist in the continuing computerization of the management information system and help improve loan collection systems;
- o A new resident advisor would be posted to West Java. An advisor will be needed to help ensure that USAID capitalization funds will be used effectively. The BPD/West Java will need assistance in devising a strategy which enables VFIs to serve village residents more efficiently and effectively; and
- o A new resident advisor would be added in East Java, per the Project Amendment.

Two options exist for technical assistance to West Sumatera. The first would be to continue posting a full-time resident advisor in West Sumatera. If USAID lacks sufficient resources to fund the above four positions plus a full-time advisor in Sumatera, then it is suggested that this province receive short-term technical assistance on an on-going basis. This could be provided by the Chief of Party and other rural credit experts familiar with the rural credit situation in West Sumatera.

During recent weeks, provincial authorities have agreed to establish coordinating units at the kecamatan level on a pilot project basis to improve LPN performance and BPD supervision. In the future, resources will be focused on improving operations of existing units rather than attempting to revive dead ones. This provides a good basis for continued technical assistance. If these plans are not implemented in a timely manner, then USAID should reconsider funding FID activities in West Sumatera.

VII. Proposed Impact Evaluation Methodology

The final evaluation of the FID project will need to address itself to the three purposes of the project: the development of existing VFIs to provide financial intermediation at reasonable cost, the creation of employment generating loan portfolios, and, the promotion of savings mobilization.

At least one year before project termination it will be necessary to decide upon final design of the impact study with special reference to method and timing of execution. The study needs to restrict itself to topics of only the utmost relevance to the project and should be consistent with local staff resources within the BPDs. External consultancy assistance will be needed for the design and implementation of the study in the field and for its subsequent analysis and report.

Personnel requirements will depend on the geographic and economic scope of the study but could involve three external consultants supplemented by a team of field staff for each province.

The sample survey will need to be carried out for each FID project province and will need to cover representative samples of VFIs, their customers and potential project participants.

Possible subject areas to be researched and covered by the impact study are listed below:

Community Level

- (1) The local and regional environment of communities serviced by village financial institutions.
- (2) Development progress in communities serviced by VFIs.

Borrower and Saver Levels

- (3) A general profile of VFI customers: education, marital status, sex, age, and domicile.
- (4) Economic sector and loan uses of VFI borrowers.
- (5) VFI customers' changes in income, employment, and quality of life.
- (6) Desires, opinions, and hopes of VFI customers.

Intermediary Institutional Level

- (7) The role of the BPD in FID implementation, including the quality of its banking administrative assistance, VFI technical supervision, and application of project funds.
- (8) Competition from similar financial institutions.
- (9) The role of non-bank governmental bodies in FID implementation: PEMDA, BAPPEDA, Badan Pembina Propinsi/Kabupaten/Kecamatan.
- (10) Desires, opinions, and hopes and realizations of project implementors.

Donor

- (11) The role of the donor in FID implementation in relation to donor efficiency and effectiveness.

Fundamental Principles

- (12) The validity of the project's overall development philosophy and operational hypotheses.

Besides conducting a sample survey in the field among the VFI customers, there will be a lot of data available for analysis from the six-monthly financial indicator figures already available and ongoing under the project. This will be supplemented by information that will be supplied by the new management information system that is now being implemented in the project areas starting in Central Java.

ANNEX A

PROJECT PAPER BUDGET

AID PROJECT # 497-0341
FINANCIAL INSTITUTIONS DEVELOPMENT

Proposed Project Budget (US\$ 000's)

	<u>AID</u>		<u>GOI</u>	<u>TOTAL</u>
	<u>Grant</u>	<u>Loan</u>		
Technical Assistance	2,000	3,500	-	5,500
Training	500	6,950	3,000	10,450
Commodities and Equipment	-	750	2,750	3,500
Capital	-	3,000	3,500	6,500
Contingency	500	1,300	-	1,800
Totals	<u>3,000</u>	<u>15,500</u>	<u>9,250</u>	<u>27,750</u>

Note : US\$ 1 = Rp. 1,000

ANNEX B

PROJECT AMENDMENT BUDGET

AID PROJECT # 497-0341
FINANCIAL INSTITUTIONS DEVELOPMENT

Proposed Revised Project Budget (US\$ 000's)

	<u>AID</u>		<u>GOI</u>	<u>TOTAL</u>
	<u>Grant</u>	<u>Loan</u>		
Technical Assistance	1,250	1,750	-	3,000
Training	1,500	3,250	1,000	5,750
Commodities	-	750	2,750	3,500
Capital	-	5,000	3,500	8,500
Contingency	250	-	-	250
	<u>3,000</u>	<u>10,750</u>	<u>7,250</u>	<u>21,000</u>

Note : GOI funds provided prior to September 1986, are still valued at pre-devaluation rates averaging approximately US\$ 1= Rp. 1,100

ANNEX C

USAID/INDONESIA

MID-TERM EVALUATION OF THE FID PROJECT: SCOPE OF WORK

1. Project Summary

Financial Institutions Development Phase I (Provincial Development Banks, or BPD) consists of training, technical assistance, and limited loan capital and commodity inputs to improve the efficiency, effectiveness, and sustainability of existing village financial institutions (VFIs) in four provinces (Central Java, West Java, West Sumatera, and East Java). The principal strategy for achieving this objective is to improve each BPD's capacity to provide technical supervision and assistance to its respective VFIs, as well as to upgrade the infrastructure and operations of the VFIs themselves.

2. Evaluation Parameters

This scope of work presents a design and implementation plan for an evaluation of the FID I project, focusing on four main issues:

- 1) appropriateness and efficiency of USAID and GOI project input delivery and utilization;
- 2) VFI efficiency, effectiveness, and financial viability;
- 3) BPD institutional development; and
- 4) validity (or lack thereof) of original project development strategies, hypotheses, and assumptions.

3. Evaluation Design

The evaluation team will rely heavily on data already generated by each BPD's management information system. As a primary FID I project objective is BPD institutional development, the improvement and partial automation of these management information systems has been a primary focus of project implementation for the past year and a half, and the data contained therein comprise a rich resource base upon which the evaluation team can build.

For example, not only have data been collected quarterly regarding the progress of FID I project implementation as measured against FID I annual implementation plans, but the following data are now available on a semi-annual basis, in standard format across all original FID I provinces, from the six-month period ending December 1985 through the six-month period ending June 1987:

DYNAMISM OF FIELD ACTIVITIES

- o loan disbursements, as indicated by loan circulation and loans outstanding;
- o loan portfolio quality, as indicated by loan collectability and the ratio of interest income to loans outstanding;
- o banking services for small-scale clients, as indicated by the average loan per borrower and the distribution of loans extended;
- o overall development of VFI banking services, indicated by new borrowers and savers, and villages currently being serviced as a percentage of total villages in the service area;
- o funds mobilization, as indicated by total savings and total time deposits;

EFFICIENCY OF FIELD ACTIVITIES

- o VFI organizational capacity and staff capabilities, as indicated by net profits per village serviced, and total VFI operational expenses per loan extended;

PROFITABILITY OF FIELD ACTIVITIES

- o VFI financial viability, as indicated by net profits and net worth; and

SUSTAINABILITY OF BPD ADVISORY AND SUPERVISORY ROLE

- o the balance between BPD profitability and quality of BPD technical supervision, as indicated by BPD subsidies to VFIs, or BPD profits derived from VFIs.

The evaluation team will not attempt to conduct a quantitative, project-wide client- or community-level impact survey at this stage of project implementation, because:

- 1) the data are neither readily available nor is the infrastructure sufficient for the collection thereof, given severe time, personnel, and budgetary resource constraints, as well as competing project demands for these scarce resources; and
- 2) except for Central Java, which has already conducted such an impact survey, project resources have not been disbursed over a period long enough to gauge the impact thereof in a credible manner, given unanticipated delays in project implementation and a natural time lag between the injection of project resources and their expected impact.

Instead, the evaluation team will draw heavily on the above noted data for its assessment of financial institutions development to date under FID I. In addition, the evaluation team will complement these quantitative data with qualitative information obtained from discussions with FID I project implementors and project participants, as well as observations from field site visits. Furthermore, the evaluation team will conduct a random check of VFI data integrity as validation or reputation of the assumption that VFI institutional development and performance is a reliable proxy for client impact. Finally, the evaluation team will present a proposed end-of-project client and community impact evaluation design.

4. Evaluation Team

The evaluation will be carried out by a two-person team comprising a mixture of skills and experience in the fields of evaluation methodology and implementation, rural banking development, and Indonesian language and culture. This evaluation team will work jointly with the Development Alternatives, Inc. (DAI) resident consultants and their Indonesian counterparts, both to increase evaluation cost-effectiveness and credibility, as well as to facilitate improvements of subsequent project implementation.

5. Evaluation Funding

The evaluation will be funded via the short-term technical assistance budget line item in DAI's FID I technical assistance contract, under USAID Project No. 497-0341.

6. Evaluation Timing

The evaluation will be conducted from mid-January to mid-February 1988.

7. Evaluation Reporting Requirements

The evaluation team will:

- o submit an outline of its final report to USAID before leaving Jakarta for the field;
- o submit a draft final report to USAID and the GOI (in English) based on the above-noted outline, followed by an oral presentation of the team's findings to USAID and the GOI, before leaving Indonesia; and
- o submit a final report to USAID and the GOI (text and annexes in English, executive summary in both English and Indonesia) within six weeks of completion of work in Indonesia.