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UPGRADING INFORMAL FINANCIAL INSTITUTIONS

Private Voluntary Organizations and Self-Help Groups Establish their own Banks in Indonesia

by

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UPGRADING INFORMAL FINANCIAL INSTITUTIONS:
PVOs and Self-Help Groups Establish their own Banks in Indonesia

- by Prof. Dr. H. D. Seibel, GTZ -

ABSTRACT

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

Contributions to this paper by Bambang Ismawan (Bina Swadaya, Jakarta), Christian Mathe (Welden, Federal Republic of Germany), Ch. Melchers (Purba Danarta, Semarang), and staff members of Lembaga Penelitian Pendidikan & Penerangan Ekonomi dan Sosial (Klaten) and of Yayasan Indonesia Sejahtera (Solo) are gratefully acknowledged.

1. The Situation of Rural Finance in Indonesia

In developing countries, there are usually two types of financial markets: formal and informal markets. In a number of countries, such as Indonesia, there is a growing third market, namely a semiformal market.

Financial markets are defined as formal, when they fall under the control of state credit and related financial laws. They are defined as informal, when they operate outside such control. Financial SHGs and individual financial brokers make up the core of the atomized informal sector, while banks are the center of the formal financial sector.

The semiformal market comprises Self-Help Promoting Institutions (SHPI), i.e., governmental and private voluntary organizations. This is a small but rapidly growing sector in many developing countries. In Indonesia, there are a number of PVOs and also GOs which support SHGs, individuals, households or families with financial and extension services. These organizations act like financial institutions, but neither do they fall under the state credit law nor are they as removed from state control or supervision as the institutions of the informal financial sector. While the informal sector, including SHGs, enjoys at best a passive tolerance of the financial control agencies, the semiformal financial sector receives the explicit or at least implicit approval of the government, of government institutions or of the central bank. However, as there is no firm legal basis, this approval may be withdrawn at any time. As the organizations in the semiformal sector are known by name to those in a position of authority in the financial system, such withdrawal of approval could not be ignored.

Many SHGs have built up their own internal savings and credit business. Some PVOs have made substantial contributions to the development and growth of financial and other self-help activities in these groups. Neither PVOs nor SHGs are normally linked to the banking sector. Even if SHGs are connected to a SHPI (PVO or GO), their facilities are limited. E.g., some SHPIs deliver loans but do not accept savings. In that case financial resources which could be applied for productive investments may remain unused.
Despite substantial contributions made by the extension of the rural banking network and by special credit programs for the development of small enterprises and of agriculture, rural finance has remained inadequate in providing for the growing needs of small enterprises and farmers among the poorer section of the population. A core problem is the insufficient supply of the rural population with suitable financial services concerning both savings deposit facilities and credit delivery. Bureaucratism and collateral requirements discourage the rural population in contacting the banks for a loan. Therefore, surplus funds are frequently not saved in bank accounts but hoarded or invested in unproductive assets. As a result the further progress of employment and income generation has been severely hampered.

2.1.2. The Situation of PVOs as Financial Intermediaries in Indonesia

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

(1) They have no access to the refinancing facilities of the central bank. As their own capital basis is usually weak, if not nonexisting, the result is a dependency on funds from external donors. Most of the PVOs are not selfsustaining institutions.

(2) They have no access to the facilities of bank training institutes. This results in a lack of proper financial skills and experience.

(3) Their activities with regard to credit and savings schemes are always limited; certain schemes, such as the National Savings Scheme TABANAS, are not accessible to PVOs. The credit supply offered by PVOs to SHGs is invariably restricted and is usually far from fulfilling the need.

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

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

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

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

3. A New Act of Deregulating Rural Financial Institutions: PAKTO 27

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

(1) Rural banks may be established in subdistricts (kecamatan) outside the capital, provincial capitals and municipalities.

(2) A rural bank operating on subdistrict level shall have a paid up capital of at least Rp 50 million. A commercial or development bank on district (kabupaten) level shall have a paid up capital of Rp 10 billion.

(3) Existing rural banks located in the capital, provincial capitals and municipalities shall either be promoted to commercial or development banks or else be moved to subdistricts. A transition period of two years is provided commencing from the issuance of the regulation.

(4) A BPR is supposed to confine its business to the subdistrict in which it is located.

(5) A rural bank may be registered under two different legal forms: either as a limited liability company (PT) or as a cooperative.

(6) No licence is required from the Ministry of Finance for a rural bank to open a branch office located in the same subdistrict as its head office. It is sufficient to report the opening to the local Bank Indonesia branch.

(7) A BPR is authorized to carry out savings and credit operations. It may mobilize funds in the form of demand, time and savings deposits and execute the Tabanas ('national savings' at 15% p.a.) or other savings schemes. Credits of these banks are to be mainly extended to small-scale entrepreneurs and the rural community.

(8) As a safeguard to the soundness of banks, these institutions are subject to legal lending limits.

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

4. The Potential of PAKTO 27 for the PVO Sector

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

(1) For the first time in Indonesia, they now have the chance to leave the shadow economy of semiformal and informal institutions and gain legal protection. The latter is particularly important in a political situation where the future of institutions without a sound legal basis of their financial and related operations cannot be secure.

(2) On such a legal basis they will get access to refinancing funds of the central bank. This could compensate their weak capital basis and reduce their dependency on external donors. Refinancing funds will be important for setting up selfsustaining and viable rural banks.

(3) With formal banking status, PVOs and SHGs will gain access to the facilities of bank training institutes. This will lead to an improvement of their financial and banking skills.

(4) By establishing new PVOs/SHGs banks at kecamatan level, the rural financial system may eventually experience a substantial expansion and improvement, particularly by providing financial services to the poorer sections of the population. For years PVOs have been active in rural areas with close contacts to SHGs and their members. Therefore, they are best suited to meet the financial needs of their target groups. Target-group oriented banking will also imply the adjustment of financial services to the rural population concerning banking procedures, savings and credit facilities, new products, opening hours, doorstep services, etc.

5. A Plan of Action for the Establishment of PVO/SHG Banks

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

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

There are various institutional alternatives for PVO/SHG banks, depending on the arrangement between cooperating PVOs and SHGs:

Model Ia: Several SHGs separately form several BPR, each giving up their own informal status

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|-----------------------------------------------|
|    several SHGs   ----->   separate BPR       |
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Model Ib: Several SHGs separately form several BPR, simultaneously maintaining their own informal status for savings and repayment collection

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|-----------------------------------------------|
|  several SHGs   ----->   separate apex-BPR    |
|-----------------------------------------------|
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Model Ic: Several SHGs join together and form one BPR, giving up their own separate status

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|-----------------------------------------------|
|                                               |
|             SHG              SHG              |
|                  \        /                   |
|                     BPR                       |
|                  /        \                   |
|             SHG              SHG              |
|                                               |
|-----------------------------------------------|
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Model Id: Several SHGs jointly form one BPR and maintain their own separate status as informal groups, collecting savings and repayments for the BPR

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|-----------------------------------------------|
|                                               |
|             SHG              SHG              |
|                  \        /                   |
|                   apex-BPR                    |
|                  /        \                   |
|             SHG              SHG              |
|                                               |
|-----------------------------------------------|
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Model IIa: One PVO forms a BPR as apex-organization with its own legal status

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|-----------------------------------------------|
|        one PVO   ----->   apex-BPR            |
|-----------------------------------------------|
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Model IIb: Several PVOs separately form several BPR as apex organizations with their own legal personality

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|-----------------------------------------------|
|  several PVOs   ----->   separate apex-BPR    |
|-----------------------------------------------|
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Model IIc: Several PVOs jointly form a BPR as an apex organization with its own legal status

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|-----------------------------------------------|
|                                               |
|            PVO                PVO             |
|                \           /                  |
|                  apex-BPR                     |
|                /           \                  |
|            PVO                PVO             |
|                                               |
|-----------------------------------------------|
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Model III: A PVO and several SHGs jointly form a BPR with its own legal personality; both PVO and SHGs maintain their respective organizational status

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|-----------------------------------------------|
|   PVO   ---->   apex-BPR   <----   SHGs       |
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There are four major phases:

Phase I: Examining the legal framework and legal procedures

Phase II: Examining the feasibility of PVO/SHG banks and working out an operational plan

Phase III: Preparatory activities, including staff training, preparations of the organizational set-up and procedures, location, equipment, provision of equity capital and provision of working capital

Phase IV: Start-up activities in the field

Phase V: The working phase

Activities required concerning Phase I will be carried out by the participating PVOs themselves in cooperation with PPHBK as discussed under 3.4 and 3.5. The following proposal will therefore be confined to Phase II.

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

(1) Consultancy services are rendered to participating PVOs concerning the feasibility and the viability of rural banks

(2) A feasibility report and a plan of action are worked out

(3) A project proposal is worked out.

The two preparatory phases entail the following **activities:**

(1) Concerning the legal framework:
- analysis of state credit and related financial laws;
- analysis of PAKTO 27;
- assessment of the legal requirements and procedures;
- recommendation of a legal status;

(2) Financial and banking skills:
- training needs assessment;
- assessment of the needs of advisory services;
- assessment of existing bank training facilities and their capacity
- working out appropriate models and forms of cooperation between PVOs and SHGs;
- working out further steps and procedures.

(3) Equity capital basis:
- assessment of capital needs;
- determining capital requirements of a viable, self-sustaining rural bank;
- working out schemes of risk-coverage;

(4) Organizational costs, risks and benefits:
- assessment of benefits to the participating organizations;
- assessment of special risks
- assessment of costs to the participating organization.

(5) Establishment of a target-group oriented bank:
- organizational system;
- design of adequate banking procedures;
- design of appropriate financial and extension services;
- design of new services and products.

(6) Assessment of viable, self-sustaining banking operations for different organizational models:

(6.1) Assessment of initial and operational cost alternatives, based on the organizational models elaborated, by defining cost centers and calculating cost effectiveness

(6.2) Determining the feasibility of self-sustaining financial operations with regard to:
(a) savings mobilization;
(b) lending operations (incl., e.g., level of interest rates to be charged; repayment schedules necessary to become selfsufficient within, e.g., one/two/three/four years; break-even loan sizes; break-even loan portfolios);
(c) capital basis.

(6.3) Elaborating proposals based on 6.1 and 6.2.

6. Relationship with PPHBK

(1) The main project which is of relevance to the proposal of establishing PVO/SHG rural banks is PPHBK, the pilot project LINKING BANKS AND SELF-HELP GROUPS. PPHBK was initiated by APRACA (Asia and Pacific Regional Agricultural Credit Association); it is supported by GTZ; project holder is Bank Indonesia; project policies are guided by a National Task Force comprising Bank Indonesia as the central bank, Bank Rakyat Indonesia as the largest bank with a rural mandate, and Bina Swadaya as one of the major PVOs in Indonesia; it comprises 11 participating PVOs and 12 participating banks.

(2) Several of the PVOs involved in the planning of PVO/SHG rural banks also involved in PPHBK.

(3) It is the objective of PPHBK to improve the system of rural finance available to small farmers and small enterprises by linking SHGs and banks. The linkage program has two dimensions:

- an institutional linkage dimension encompassing links between SHGs and banks, which may be either direct or indirect, involving PVO in a consultative function or as financial intermediaries;

- a financial linkage dimension encompassing fixed or dynamic ratios between savings and credit, with the amount of credit contingent upon the amount of savings and the number of satisfactory repayment cycles - to ensure a gradual process of growth of the balance between credit and the borrower's capacity to save, invest and repay.

On principle these linkages between banks, PVO and SHGs are self-financed and selfsustained. Therefore, the project aims at market rates for group savings and loans.

(4) As institutional development of participating PVOs is one of the objectives of PPHBK, the establishment of rural banks by PVOs and SHGs is accorded high priority in terms of development policy. However, the actual form of cooperation, and assistance rendered, is contingent upon the different orientations of the two approaches to the development of rural finance.

Between PPHBK and the PVO/SHG rural bank project, there are some joint and some separate stages of development. If they are coordinated, the impact may be beneficial to both projects. Stage A may be a partially joint stage; stage B would entail separate but coordinated stages; stage C may be a final stage of cooperation:

(A) Joint stage: Building up financial strength through internal fund generation and incipient linkages with banks

- Internal savings mobilization and loan fund generation:
  - Members save with SHGs
  - Savings are used for an internal loan fund
  - Small but increasing loans are given to members from the internally generated loan fund
  - SHGs charge high interest rates to their members in order to increase the internal fund
- Incipient linkages with banks
  - Initial savings are deposited by SHGs in the bank (in addition to the internal loan fund)
  - Regular monthly savings are deposited in the bank
  - Credit is given by the bank to the SHG, initially at a relatively low savings to credit ratio
  - The dilemma between internal and external finance during the initial phase:

    The more savings a SHG deposits with the bank as a basis for bank loans to the group, the less money is internally available for internal lending. As this is paralleled by increasing bank loans, the overall liquidity of the group and of the members is improved, yet at the partial expense of the internal loan fund.

    As there is a tendency of confining external loans funds to income, employment and production generating activities while the internal fund is also used from household expenditure, emergencies and consumption, the impact may be a net transfer of available loan funds to economic activities. Simultaneously there might be a shortage of funds for emergency and consumption purposes.

(B-1) PPHBK: Building up financial strength from internal and external sources through strong linkages with banks

- In financial transactions between SHGs and banks, the ratio of savings to credit increases
- As a result of an extra margin charged by SHGs when onlending to members, the internal loan fund grows, which means an increase in internal financial strength of the group
- Simultaneously, there is a further increase in the relationship with banks as refinancing institutions

(B-2) PVO/SHG-BPR: Preparations for the establishment of rural banks

(C-1) PVO/SHG-BPR: Establishing PVO/SHG banks

- PVO/SHGs establish their own rural banks
- These rural banks have access to refinance from Bank Indonesia at the lower central bank refinancing rates

(C-2) PPHBK: Collaboration with PVO/SHG banks

- PPHBK lends its usual support to PVO/SHG banks, including training, consultancy services and access to BI refinance

- PPHBK promotes linkages between the new PVO/SHG banks and other self-help groups

- At the same time, PPHBK continues its cooperation with other banks, PVOs and SHGs who in the future may establish their own banks and promotes linkages between them and the already established PVO/SHG banks

- PPHBK also continues to initiate and support linkages between other banks and SHGs.

PPHBK can assist PVO/SHGs which intend to establish their own rural banks in two phases:

Phase I: PPHBK, in close collaboration with the Bank Development Department of Bank Indonesia, may assist participating PVOs in working out the legal framework, requirements and procedures for establishing new rural banks.

Phase IV: Once PVO/SHGs have succeeded in establishing their own rural banks, such banks may enter the project supporting and benefit from its supportuning services and activities. In particular, this may include training of staff, institutional development, research and monitoring services and consultancy services, in addition to the special assistance and protection given in the framework of a project with the central bank, including the permission to do business with informal self-help groups and access to central bank refinancing facilities.

As PPHBK is integrated into Bank Indonesia's organizational structure, continued assistance to participating banks is virtually guaranteed beyond the life cycle of the pilot project.

7. Impact Assessment

As a result of the proposed establishment of rural banks by PVO/SHGs, an increasing number of the poorer sections of the rural population are expected to get access to adequate financial services. This should have positive effects on the economic development in rural areas, as more financial facilities will stimulate savings activities and small credit delivery. The efficient use of credit will be supported by training courses and advisory services of the PVO. A positive influence on income generating and job creating investments by rural microentrepreneurs is expected.

8. Summary

In Indonesia, financial markets are segmented into formal, informal and semiformal financial markets. Financial self-help groups (SHGs) and private individual lenders make up the core of the informal market, operating without legal status. Many SHGs are connected with self-help promoting institutions (SHPI), which may be governmental (GOs) or private voluntary organizations (PVOs). These institutions act in what may appropriately be called a semiformal financial sector. They support SHGs with financial services, technical advice and training courses. Banks are at the core of the formal financial sector.

Access of the rural population to the services of the banking system is restricted. Among the limiting factors are the insufficient extension of branch or village unit networks, an inadequate adjustment of financial services to the needs of the rural poor, a lack of collateral and the social distance between poor people and banks. In many areas, facilities to deposit savings are missing or too distant; for many small farmers, small entrepreneurs and poor people in rural and urban areas, access to credit is effectively barred. As a result, financial resources are not mobilized and cannot be used for productive investments, income generating activities or employment creation. All this slows down the progress of individual and family welfare and the process of development in rural areas.

Since 1983 the government of Indonesia has made new efforts to stimulate economic development by reforms in the economic and financial sector. On the whole, frame conditions for private enterprise as well as private organizations have been considerably improved by successive acts of deregulation. As the latest step, in October 1988, **'PAKTO 27'** was issued, a package which aims at the invigoration of fund mobilization and fund allocation by improving the financial system and further deregulating money and capital markets. Restrictions concerning the opening of new

banks, branches or village units have been eased. For the establishment of a **rural bank operating at subdistrict (kecamatan) level,** equity capital of Rp 50 million (appr. US$ 28,000.-) is required. Provision has been made in PAKTO 27 for two different legal forms of rural banks (BPR): In the case of a limited liability company (PT), this capital may be raised from private investors; in the case of a cooperative bank, the capital may be raised in the form of paid-up savings of the members of the cooperative.

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

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

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

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

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

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

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