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**Microenterprise Credit in Indonesia
Overview and Implications for Donor Policy**

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CONTENTS

Introduction	3
Part I. Achievements	3
Part II. Analysis of Success: What Made This Possible?	7
Part III. How the Systems Work	12
Service Delivery Methodology: Minimalist Credit	12
The Role of Savings	16
Structure and Operations: Village Units	18
Supervision and Ownership	21
Part IV. Origins and Development of the BRI and BPD Systems	25

INTRODUCTION

The provision of financial services to microenterprises in Indonesia is maturing into a complex and vibrant industry. Banks of several sorts are making profits serving the enterprises of the poor, carving out market niches for themselves, and beginning to compete with each other for business from the same clientele. The profitability of the established institutions, namely the Badan Kredit Kecamatan in Central Java and its sister institutions in other provinces, and the Unit Desa system of the Bank Rakyat Indonesia, encourages new entrants into the industry. The central government is taking the first steps to regulate the industry as a full fledged aspect of the financial system. In this process, millions of customers are being served and more than a billion dollars have been lent. Few nations can boast that their microentrepreneurs are so well supplied with savings and credit.

Conditions and events in Indonesia have been particularly supportive of the development of the microenterprise finance industry, but many of the same conditions can be found in other developing countries. It may be possible to build similar systems in many countries, if governments, donors and local organizations work together. The development of the Indonesian system has, in fact, been made possible by the combined and sustained effort of the Government of Indonesia and external donors (primarily A.I.D. and the World Bank).

This paper discusses the Indonesian experience in microenterprise finance from the point of view of its potential for replication in other countries. It attempts to identify factors that explain the success of that experience and to highlight the role of government and donors. Information is also presented on the structure and organization of the systems. The paper builds on three evaluation reports carried out by the GEMINI Project for USAID/Indonesia: an institutional evaluation of the BKK and sister institutions; an impact evaluation of the same institutions; and an institutional evaluation of the BRI Unit Desa system.¹

PART I. ACHIEVEMENTS

Two main systems provide savings and credit services to the smallest enterprises throughout Indonesia. The Bank Pembangunan Daerah (BPD) system consists of separate institutions operating in each of seven provinces, and owned by provincial and district governments. The oldest and best-known of these is the Badan

¹ James J. Boomgard and Kenneth J. Angell, "Developing Financial Services for Microenterprises: An Evaluation of USAID Assistance to the BRI Unit Desa System," Development Alternatives, Inc., September 1990. Other papers in progress.

Kredit Kecamatan (BKK) in Central Java. In each case, the provincial development bank, the BPD, supervises the system. The second system is the Unit Desa System of the Bank Rakyat Indonesia (BRI). BRI is a large government-owned commercial bank, whose Unit Desas (village units) operate throughout the country. The BRI Unit Desa system may be more familiar to some readers as KUPEDES, the loan program offered by the Unit Desas.

Table 1 summarizes the achievements of these institutions in terms of the level of services provided and funds mobilized.

TABLE 1. Volume of Activity in BPD and BRI Systems, December 1989
(In millions of U.S. dollars)

Activity	BPD Systems*					BRI Unit Desa
	W Java	C Java	E Java	Bali	All BPD	
Lending:						
Volume outstanding	13.625	12.701	1.885	2.777	33.251	614.500
Number of loans	122,949	509,584	113,742	38,605	828,580	1,800,000
Average loan size#	\$202	\$25	\$17	\$72	\$40	\$437
Savings:						
Volume	12.198	2.559	0.492	2.345	18.432	646.800
Number of savers	288,269	500,563	140,289	68,542	1,050,027	6,700,000
Average savings	\$69	\$5	\$4	\$34	\$18	\$97

* Data for all BPD includes three provinces in addition to those shown: West Sumatra, South Kalimantan, and Nusa Tenggara Barat.

Average amount of loan outstanding, including those partially repaid. Initial loan sizes are roughly twice as high, but are not available.

Each of the BPD institutions has a slightly different structure, and each has been operating for a different amount of time. This makes comparisons across provinces somewhat inappropriate. The BPD systems are currently serving more than 800,000 borrowers, and the BRI Unit Desa system now reaches 1.8 million. A total of \$647 million in loans are outstanding. Even at this impressive level, the systems have not yet reached their full potential, as the very rapid growth in some of the systems shows. The smaller systems, such as those in East Java and Bali have only recently been revitalized, and in recent years have posted growth rates of more than 100 percent per year. Even the BRI system, now six years old, continues to grow at roughly 35 to 40 percent per year.

Loan sizes are very small, indicating that the programs are reaching genuinely poor customers. The BPD systems, which operate posts in villages, provide significantly smaller loans. Because

of this, they tend to serve lower income customers, those whose activities are restricted to the villages.

The systems that have made voluntary savings a priority, namely BRI, West Java and Bali, have been rewarded by attracting savings that fully or almost fully support lending activities. Thus, they have demonstrated that lending to the poor need not be based on external sources of funds, but can rely on the savings of the same communities and, in fact, that more people are interested in saving, given a convenient, safe mechanism, than in borrowing.

As impressive as the reach of these systems is their profitability and general financial health. If judged by commercial banking criteria, these systems perform quite well, as shown in Table 2.

TABLE 2. Financial Performance of BPD and BRI Systems, December
• 1989

Indicator	----- BPD System		----	BRI
	C Java	E Java	Bali	Unit Desa
Profitability:				
Return on Average Assets	6.3%	30.0%	15.2%	3.6%
Liquidity:				
Loans/Total Assets	84.6%	96.1%	82.5%	76.9% *
Asset Quality:				
Past due loans/ Gross loans	19.7%	8.5%	n/a	5.4%
Capital Adequacy:				
Equity/Loans out.	37%	43%	15%	n/a #
Growth Rate:				
Loans	12%	140%	119%	57%
Savings	26%	406%	144%	95%

* For BRI, the liquidity measure used is loans/(deposits plus borrowings).

As a program of a larger bank, the BRI Unit Desa system does not have its own equity capital.

The most important observations are that all of these systems generate strong profits and that they are growing rapidly, especially in savings, in line with the adoption and use of improved savings vehicles. The BRI system is financially the strongest, with what is judged to be excellent profitability by

international standards, good liquidity and good asset quality.² The financial picture for the BPD systems looks quite different, largely because these institutions are highly capitalized. A major portion of the funds they use for lending is equity from original donor or government capitalization and from retained earnings. As they pay no interest on equity, their cost of capital is low, and profitability high. The system in Bali, because it is more oriented toward savings than the other two systems shown, has a higher cost of capital and lower profits.

The difference in profitability between East and Central Java lies primarily in a serious arrears problem in Central Java, which reduces interest income. The current arrears problem is not as severe as it appears from these figures, however, because the BKK has only just started writing off bad loans, some of which have accumulated over a 19 year period. Arrears management is one of the most important problems facing the BPD systems at this time, but they have not had to reckon with that problem because their strong equity position shields them. This issue will be discussed further below. The system in East Java is facing liquidity problems, which are associated with its rapid growth, as one of the smallest, youngest systems.

While these systems are not free of problems and risks, they have achieved better results than virtually any system serving microenterprises, with the possible exception of the credit union systems in several countries. It is often argued that the success shown here results from a confluence of factors unique to Indonesia. The next section of this paper examines the elements of the system and its context one by one, to determine just what those factors are, and whether they are indeed unique. The conclusion will be that while Indonesia has provided a favorable environment, the necessary conditions are by no means limited to Indonesia.

² See Angell and Boomgard.

PART II. ANALYSIS OF SUCCESS. WHAT MADE THIS POSSIBLE?

In examining the reasons behind the achievements of the BPD and BRI systems, we will look at what makes these systems operate successfully as they are now. Part III of this paper reviews the process through which these systems came into being, and considers their environment and the involvement of government and donors. Part IV discusses the three elements of the systems, which must all function in support of each other: 1) the service delivery methodology; 2) the individual lending and deposit-taking units, which are the cornerstone of financial self-sufficiency; and 3) the supervisory structure, which enforces and enables good management by the units. The remainder of Part II summarizes the key points that are developed in the later sections, in a form attempts to distill the lessons that governments and donors may learn from the Indonesian experience.

While developed solely from the Indonesian examples, these conclusions are presented as general principles to apply to any attempt to design or improve financial services for the poor and microenterprises. Not all may prove transferrable to other contexts. However, they and the Indonesian experience generally represent a gauntlet thrown down to challenge other countries.

Two points apply to the experience in Indonesia as a whole:

- o The poor can be viable financial system customers. Few of those involved in financial markets outside Indonesia believe this lesson, but it is demonstrated beyond doubt here.
- o "Getting incentives right for borrowers, savers, employees, and managers has been a key ingredient in evoking the desired behavior on the part of each set of actors,"³ and has been essential for making these systems work. Where incentives have not been right, weakness has appeared.

The remaining points are grouped according to categories used in the body of the text.

Service Delivery Methodology: Minimalist Credit

- o The systems have shown the validity of minimalist lending principles for reaching the poor:
 - Ready access to credit matters more to these customers than its price.

³ Boomgard and Angell, p. 63.

- Highly simplified procedures for loan applications and supervision bring per loan costs to a level commensurate with loan size, and create the foundation for the lender's financial viability. The smaller the loans, the simpler the procedures must be.
- A web of repayment-motivating provisions allow lenders to use simple procedures without incurring risk of default. These include subtle forms of social pressure, the prospect of repeat loans, positive incentives for repayment, and informal collateral.

These principles for reaching the poor have proven successful in many other countries, as well as Indonesia. They are at the heart of successful systems such as Grameen Bank and the programs affiliated with ACCION International.

- o The differences between the BPD systems and the BRI Unit Desa system show that techniques vary with target population and loan size. There is in fact a continuum from pure minimalism to pure commercial banking. BPD stands at the minimalist end, while BRI has successfully incorporated some elements of more traditional banking practice in order to reach its better-off customers.
- o Lending to the poorest customers can be viable without group mechanisms. If individual loans work better than group loans in Indonesia, they may also work better in other countries.

Voluntary Savings

- o Lending to the poor can be financed by savings from the same communities, provided that savings is treated as a service, and designed with customer needs in mind.
- o Successful savings instruments offer convenience, ready access to money, and a positive real return.
- o More people want a good place to save than want loans. Thus, savings services can reach deeper into the community. The opportunity to save should not be limited to those who borrow, as it is in many other programs.
- o Systems that provide both savings and borrowing are more self-sufficient and integrated into their communities.

- o Systems that accept savings incur fiduciary responsibilities that require added supervision. Without it, they are vulnerable to crises of confidence and abuse.

The Village Unit Structure

- o The success of these systems is built around the individual units (or branches) operating as profit centers. Such units can produce strong profits!
- o In establishing these profit centers, it was crucial that they were treated much like any business start up. They were provided with initial investment, and expected to achieve profitability within a few years (generally three).
- o The basic characteristics of unit scale, as described in the text, including the number of borrowers per staff member, provide challenging performance targets for those designing other minimalist systems.
- o Operating costs at the units are very low, particularly in the BPD systems. Much of the cost savings results from creative use of existing resources, such as under-used buildings.

Supervision and Ownership

- o The incentive structure crucial for achieving good management and financial performance must have the following elements: 1) supervisors must have a stake in the performance of the units, and 2) they must be able to enforce their decisions. Training and management information without these incentives is not sufficient.
- o The task of building a sound supervisory structure and training unit staff in desired management techniques requires a great deal of time and expense. This is an area where external support is most needed.
- o Technical inputs, such as advisors, training and management information systems, which A.I.D. has provided, have been essential to improving the performance of both the BRI and BPD. The good practice introduced through that assistance has not permeated the BPD systems as fully because appropriate incentives are not in place. Technical inputs can provide the way, but cannot provide the will.

- o It is advantageous for individual units to be linked to a superstructure, for spreading the lessons of trial and error efficiently, for managing liquidity, and for increasing financial intermediation. This is a particularly important issue for individual programs or programs owned at the community level to grapple with. While locally-owned units have their own benefits, they need access to these system-wide functions of the superstructure.
- o When savings are being mobilized, at least some government financial regulation become necessary, to safeguard depositors interests.

Origins and Development

- o If development of microenterprise credit is treated by government as part of financial systems development, powerful results may follow. The government should seek to play a demonstration role, which consists of both setting conducive policies and supporting the development of capable institutions.
- o In setting up financial services, profitability or financial self-sufficiency is vital. Governments and donors must approach the task as a business start up, by, for example, providing the start up investment, but the financial institutions should operate as businesses from the beginning. Three years is not too long to require self-sufficiency of service provision, though establishing a well-functioning institutional superstructure will take longer.
- o Governments must allow and encourage institutions to pursue financial self-sufficiency through full cost pricing and savings mobilization. In many countries neither of these is permitted. Interest rates must be set by financial institutions in keeping with their costs and what the market will bear.
- o Microenterprise finance requires active participation by governmental institutions (or non-governmental institutions supported by government). Private, for-profit lenders will not move into this field unless its profitability is clearly demonstrated. The government must play a demonstration role. In Indonesia the

demonstration is so successful that private banks are now seeking to enter the field.⁴

- o Development of microenterprise finance systems should be carried out at two levels simultaneously: financial market policy and institutional support. Policy alone is not sufficient to induce institutional changes, and institutional support will not work without conducive policies.
- o Recognizing the above, donor support should operate at both levels. Development of microenterprise finance systems belongs on the policy dialogue agenda, and donors should back up their prescriptions with the opportunities and know-how to make them operable.
- o Political motivations can spark action, but must be governed by market principles. In this case, the central government's political objectives in starting these systems provided needed commitment and a belief that the activity was important.
- o Continuity of technical advisors, even spanning several individual project lifetimes is rewarded by the development of government confidence in the advice. This is an obvious precept, but is demonstrated splendidly in this instance.
- o Social and economic conditions in Indonesia contributed to the success of these systems, but do not explain that success. Examples of conducive elements include village cohesion, population density, general economic growth, and low inflation. Not all the contextual elements found in Indonesia will occur in other countries, but many will, and it is likely that systems in other countries can be adapted to fit.
- o Failed target credit programs and development banks litter the third world landscape. Governments have nothing to lose and much to gain from taking on the challenge posed by the experience of microenterprise finance in Indonesia.

⁴ Similarly, the U.S. government played a major demonstration role in the development during the 1930s and 1940s of the long term home mortgage loan, now the backbone of a major private industry.

PART III. HOW THE SYSTEMS WORK

Service Delivery Methodology: Minimalist Credit

At the foundation of the Indonesian systems is a method of delivery of services, often called minimalist credit, which, unlike many other lending methodologies, manages to close the gap between the needs of the customer and those of the financial institution. Minimalist credit programs share three elements:

- o They provide services that fit customers' needs and capacities. Short term loans (one year or less) are the staple offering, with an emphasis on convenient and quick access to funds, rather than on price.
- o Streamlined procedures reduce the unit cost of lending to a bare minimum. Loan applications and approvals are extremely simple.
- o Special techniques are used to motivate repayments. The key to the success of minimalist credit is that it motivates borrowers to repay through social pressure and positive incentives. Assurance that borrowers have strong motivations to repay acts as a substitute for the costly information gathering processes used in most credit delivery systems.

The BPD systems represent a pure minimalist approach. The BRI Unit Desa system, which makes significantly larger loans, to a presumably better-off clientele, uses a mixed approach. It incorporates aspects of both minimalist credit and traditional banking practice. As they operate side by side, the two approaches demonstrate clearly how loan size defines the type of lending techniques that are profitable, and therefore illustrates differences in technique appropriate for differing target groups.

Let us examine how each of the three elements of minimalist credit is embodied in the BPD and BRI systems, taking the customers' needs first. All the BPD systems provide short term loans, generally either three months or one year in duration, with rapid turn around time. First loans are generally disbursed in a week, while repeat loans may take no more than one or two days. To further simplify matters for the borrower (and for staff), the interest regimen is fixed, and based on flat percentages of the loan, rather than on declining balances. No complicated calculations are involved. For example, in the BPD systems of East and Central Java loans are made for three months with weekly repayments. Each payment is 10 percent of the loan amount. The first payment covers all interest charged. The second is a forced savings payment, which is returned to the borrower after the loan is fully repaid. Principal is repaid in the remaining ten installments. Because of the small

unit size of the loans, interest rates must be high. In keeping with the observation that access to credit matters more than price for most of the poor, the high rates have not deterred demand.

The effective annual interest rate for loans in East and Central Java is 84 percent. The systems in Bali and West Java offer mainly annual loans, repayable in monthly installments of 15 percent of the loan amount, at a somewhat lower effective interest rate.

Because they make larger loans, the BRI unit desas can afford to offer more flexibility in loan terms. Most still have the minimalist attributes of being short term (most are between three and twelve months in maturity) and high interest (1.5 percent of the original principal each month, which yields an effective annual interest rate of 32 percent). As inflation in Indonesia has been below 10 percent during most of the past decade, these charges represent very high real rates. Nevertheless, the rates these systems offer are far below those available from informal moneylenders. They are substantially above rates offered to large rural enterprises by commercial banks, which range typically between 20 and 25 percent. (The larger of the loans made by the BRI unit desas, those over Rp 3 million, carry similar rates).

It is easy even for an illiterate villager to apply for a loan at the BPD posts. The staff member fills out the half-page loan application on the basis of a few minutes conversation. The application covers name, address, nature of business, use of loan and amount requested. Those who cannot write sign their applications with a thumbprint. Perhaps most importantly, the BPD posts (of which there are roughly 4,000 in seven provinces) are located in villages, near village markets, so borrowers do not have to spend much time or money to go there. BRI outlets (3,500, nationwide) offer nearly the same ease of application, but they are located in larger towns, the sub-district (kecamatan) capitals. This location accounts in part for their larger loan size and somewhat better-off clientele: they reach more mobile borrowers and borrowers carrying out the relatively sophisticated types of enterprises that are found in towns. The importance to villagers of ease of access is demonstrated by the fact that villagers use the BPD systems when they are closer to them even though the BRI units offer cheaper loans. To summarize, the BPD and BRI systems serve their customers' needs, by making loans quickly, for short terms, on the basis of simple application procedures, and by being in convenient locations.

The second element of minimalist credit, listed above, is the use of techniques that cut costs to the lowest possible level. Many of the same techniques that make it easy for customers to use the services also make it cheap for lenders to operate, such as simple applications and limiting services to one or two set products. The BPD systems further reduce costs (and enhance convenience) by offering village services through posts, which consist of two staff

members and a motorcycle, operating once a week out of buildings normally used for other purposes, such as village government. Differences between the BPD and BRI systems illustrate clearly how services must be simplified as loan size goes down. The BRI unit desas use a more complicated loan application process, involving site visits, simplified business appraisals, and collateral appraisal. The amount of staff time required per loan is significantly higher than for BPD system loans, and staff must be more highly skilled (at a cost in salaries and training expenses) but BRI finds that its own risk/return tradeoff works best with slightly more investigation, higher costs, but larger loans. Each system has fine tuned these elements to arrive at a balance between costs, risks and customer needs.

The third element in minimalist credit is selecting and motivating borrowers to ensure good repayment performance. Standard commercial banking practice relies on information about enterprises to select borrowers and tangible collateral to motivate repayment. Minimalist credit uses very little information, relying more on motivational techniques, both for self-selection of borrowers and for repayments. The approach is often called character-based lending, but no one can say for certain which aspect of the techniques actually accounts for their success. In the Indonesian systems the following elements are used, though not every element appears in every system:

- o Borrowers must obtain the signature of the head of the village (kepala desa) before the application is complete. On its face, the kepala desa's signature is only intended as evidence that the borrower is who he or she claims to be, and is indeed engaged in the enterprise stated on the loan application. However, involving the kepala desa makes borrowing an act taken as a member of a community, and therefore creates a social obligation to repay. The kepala desa can also be called upon to urge late payers to reform. In addition, loan applications require a cosigner, normally the applicant's spouse.
- o Borrowers are further motivated to repay by the promise that they will then be eligible for repeat loans. This is one of the strongest sources of motivation.
- o Initial loan sizes are small. They grow as borrowers demonstrate that are good customers. In the BRI system borrowers are classified into five categories on the basis of their repayment record and this classification establishes the loan limit for a subsequent loan. (This provision is often neglected, however.) The principle behind this provision is to limit the lender's exposure to unproven clients.

- o Forced savings and (for BRI) a refundable prompt payment fee are forfeited if borrowers fail to repay on time.
- o BRI unit desas, which begin to move up from bare bones minimalism towards standard banking practice, require collateral, most often evidence of possession of a house plot. However, this collateral is not legally binding. Generally, BRI has no means to acquire the collateral in the event of default. The collateral serves, then, as an assurance to BRI that the borrower has some assets and is willing to take loan repayment obligations seriously. Most of the effect is psychological. For their larger loans, over about \$500, BRI asks to hold the land title, while for smaller loans, it only requires evidence of possession, such as a tax receipt.
- o Finally, BRI loan managers are taught to make quick on-site appraisals of the borrowers' business capability, involving simple cash flow and balance sheet calculation. These can be completed in a matter of one to two hours at the borrower's place of business. They are used largely to determine appropriate loan size.

It is fruitless to attempt to determine which provisions are most powerful in inducing borrowers to repay, should one wish to select the most important provisions for replication. Judging from the variation both in policy and in enforcement of policy from one system and province to another, any one element could be removed or altered without seriously damaging the whole package. Suffice it to say that combinations of borrower selection techniques and repayment motivations that are used in the Indonesian systems are effective, as long as the unit takes collections seriously. Where arrears are high, as in Central Java, this appears to result more from management weakness than from a flaw in lending methodology.

Some have argued that the BRI Unit Desa system is superior to the BPD systems, citing large numbers of clients and tight financial performance as evidence. While BRI's performance may indeed be judged superior, it is unwarranted to conclude that this results from BRI's mixed rather than pure minimalist methodology and larger loan size. All the systems have developed effective variants on the minimalist themes that allow them to provide services their particular customers want, at low cost, and to motivate repayments. As the next section discusses, these variations all generate profitable operations.

TABLE 3. Comparison of BPD and BRI Systems, December 1989

Activity	BPD System			BRI	
	W Java	C Java	E Java	Bali	Unit Desa
Units:					
Town units	311	502	148	--	2800
Village posts/units	20	2938	1127	264	700
Loan Terms:					
Minimum size	\$5	\$5	\$5	\$5	\$15
Maximum size	\$1,100	\$550	\$300	\$1,100	\$2,700*
Maturity	1 year	3 months	3 months	1 year	both
Repayment freq.	monthly	weekly	weekly	monthly	monthly
Effective interest	35%	64%	84%	35%	32%
Borrower Selection Requirements:					
Kepala desa sign	yes	yes	yes	yes	yes
Larger loans for good performers	yes	yes	yes	yes	yes
Prompt payment incentive	--	yes	--	--	yes
Enterprise assessment	brief visit	brief visit	brief visit	brief visit	simple appraisal
Collateral	--	--	--	--	semi-formal
Voluntary savings:	yes	yes**	pilot	yes	yes

* Raised to \$13,500 in May 1990; no experience under new limit yet.
 ** BKK offers certificates of deposit only. It will introduce more suitable passbook savings later in 1990.

The Role of Savings

Not satisfied merely with demonstrating that it is possible to lend profitably to large numbers of microenterprises, the BPD and BRI systems have recently shown that such lending can be financed primarily by the savings of customers and their neighbors.

One of the key unresolved issues within the microenterprise community today is whether microenterprise sector credit needs can be satisfied by funds raised from the sector itself. Financial market theorists say yes, for several reasons. It is generally the case that while enterprises (of all sizes) are net borrowers, households tend to be net savers. As microenterprises are closely integrated into households, their needs for savings and credit services are likely to balance each other. Further, it is well documented that poor people save in tangible assets, and presumed

that, like better off people, they will move assets into financial form if attractive financial instruments are offered. The poor will be interested in both higher returns, and access to assets - liquidity. In addition to these reasons for predicting that savings can finance lending, one might add that savings mobilization is desirable in itself. The function of savings mobilization to put assets into more productive uses is believed to be the main contribution of the financial system to economic growth. Finally, savings are important to the ability of credit institutions to be sustainable, and to gain legitimacy as part of the local community.

Most practitioners are not so certain about the potential of savings, with the clear exception of those in the credit union systems. This is hardly surprising, given the paucity of programs that have attempted to integrate savings and credit services fully. What might be called the old view of savings held that poor people did not know how to save, and had to be taught, and even forced to develop good savings habits. This view is reflected in the early design of the BKK system (and many other microenterprise credit programs), which incorporated forced savings into loan repayment schedules. The forced savings worked well as a source of liquidity for the lenders and as an aspect of repayment motivation. However, it did not stimulate true savings behavior.

The new view of savings mobilization is that its potential will only be realized when financial institutions provide incentives to save by offering savings as a service, stressing convenience, access and returns. BRI incorporated this view into its unit desa system from the beginning. It offers SIMPEDES, a passbook savings instrument with no minimum balance, unlimited withdrawals and an interest rate close to that available to larger savers at commercial banks. Since the introduction of SIMPEDES, BRI has seen its savings grow faster than lending to the point where, in 1989, savings exceeded loans. It has also found that its savings services reach many more people than credit services, by a factor approaching four to one.

More recently, the BPD systems have attempted to increase their savings mobilization efforts. The systems in West Java and Bali are now primarily financed through savings. BKK introduced a savings instrument, certificates of deposit, but this instrument proved unpopular with both customers and BKK staff, and has not generated significant amounts of funds. By contrast, KURK in East Java began a pilot passbook savings scheme in one district in early 1990. This is generating deposits so quickly that KURK is optimistic about being able to become largely savings-financed soon after it introduces the scheme throughout the province. As the BPD systems develop their savings services, they may begin to make inroads into the clients now using BRI unit desas; in interviews a number of BPD system borrowers said that they saved at BRI.

Presumably many would switch to BPD outlets located nearer their homes.

As these financial institutions become increasingly dependent on savings for their funds, they will begin to face a set of more complex financial issues than those facing lending units. Savings generated must be placed into income-earning assets quickly, to cover the costs of generating them. Loans earn higher income for the BPD and BRI systems than do other options, such as placing funds on deposit with parent financial institutions. Therefore, as savings increase, so will pressure to make loans. This pressure can easily be relieved by making larger loans, and it can be seen that the average loan size of the savings-based systems (BRI, West Java and Bali) offer far larger loans than the others (Central and East Java). This may tend to push systems to serve better off clients, and in may lead them to make riskier loans. However, at the same time, the institutions must manage risk well in their loan portfolios, so that borrowers will continue to place confidence in the institutions and therefore continue to save there. Like any financial institutions, these systems are vulnerable to collapse if borrower confidence begins to erode. This fact, together with the need to ensure that depositors funds are handled appropriately, calls for ongoing government supervision of the financial soundness of the institutions. During the next decade, which promises to see the advent of much stronger competitive pressures in the industry, the Indonesian government will have to maintain close watch on developments.

The key conclusions for donors and governments from the savings experience of the BRI and BPD systems is that whenever savings is approached as a service offered on attractive terms, customers respond enthusiastically. Indications are that savings can finance lending, and that when both savings and lending are offered, a certain amount of borrowing behavior is transformed into savings behavior (see next part). It is incumbent upon donors and governments to encourage microenterprise finance institutions to offer savings services. They must do this by refusing to establish themselves as long term sources of funds. Moreover, they must establish a policy and supervisory framework that allows these programs to take deposits and helps them manage them safely.

Structure and Operations: Village Units

The BRI system and BPD systems are constructed of individual units, each operating as a profit center, held together by a supervisory structure that sets policy, monitors performance and provides training. The key to the financial self-sufficiency of these systems is the cost and return structure the individual units are able to achieve. Understanding this structure is therefore critical in examining the potential for replication of similar systems in other countries.

Table 4 shows the structure of a typical unit in East Java's BPD system, known as KURK. KURK is a relatively new system, and in 1989 it did not yet offer voluntary savings. While not typical, it can serve to illustrate some common features of all the systems. Each KURK unit is staffed by three people: a manager, cashier and bookkeeper. These three people handle a client load of 768 people, or 255 borrowers per staff member. Most, but not all staff have completed high school. They are paid between 60,000 and 80,000 rupiahs per month (\$32 to \$43). Comparable jobs in the private sector would pay higher wages, but there is still intense competition for KURK positions, because of high unemployment among those seeking office jobs. The staff also receive bonuses at year end, of more than one month salary, if their unit performs well. In addition, KURK pays a village worker at each post to help bring in repayments. This worker receives a small percentage of all loan installments collected. The labor costs faced by the KURK and the other BPD systems are extremely small.

Other operating expenses are also quite small. KURK units pay little or nothing for rent, as they occupy otherwise under-used office space belonging to subdistrict and village governments. The main administrative expenses cover the costs of motorcycle travel to posts and office supplies, such as forms, pens, and calculators. Bookkeeping is done by hand. KURK units must pay interest on the initial capitalization loans they have received from A.I.D. through the BPD, at an effective rate of 12 percent. This is a low, but not significantly subsidized rate; a market cost of capital would be between 12 and 15 percent.

KURK units are highly capitalized, with equity representing more than half of loans outstanding. This equity has been built up through years of retained earnings, both from the predecessor system to KURK, which KURK inherited when it was established in 1988, and from earnings in the most recent years. KURK units retain about 60 percent of their profits, paying about 10 percent in staff bonuses, and distributing the remaining 30 percent to provincial and local governments. The large equity holdings reduce the average cost of capital.

To summarize, the village unit for KURK, as for all the BPD systems, is an extremely simple operation, capable of handling a large volume of transactions at very low cost.

TABLE 4. Typical BPD Unit Structure, East Java
(KURK System, 1989)

Activity	U.S. Dollar Equivalent
Income and Expense Statement	
Income:	
Interest income	7,087
Late charges	160
Other (salary subsidy and loan recoveries)	2,106
Total	9,354
Expenses:	
Salaries	1,445
Administrative	633
Transportation	165
Interest paid	209
Loan loss reserve	312
Other (includes incentive for village workers)	700
Total	3,465
Profit	5,889

Balance Sheet (Prior to Distribution of Profits)	
Assets:	
Cash on hand	271
Cash in bank	564
Loans	12,739
Loan loss reserve	(48)
Total	13,526
Liabilities and Equity:	
Forced savings	3,329
Loans from BPD/AID	3,124
Equity paid in	2,775
Current and retained earnings	4,298
Ret. earnings, 1989	2,947
Total	13,526

Lending Activities	
Volume of Loans Outstanding	12,739
Number of Loans Outstanding	768
Number of staff	3
Number of Posts	8
Borrowers per staff member	255

The BRI units are fairly similar to those of the KURK, but there are several important differences. BRI Unit Desas are staffed by four people, who receive substantially higher pay than KURK employees and who, on average, hold higher qualifications. Other operating costs are also higher, as premises are more substantial. The biggest difference, however, is that BRI units lend mainly from

savings they have collected and do not have the large store of retained equity to use as loan capital. Like all the systems that rely on savings (BALI and West Java), BRI unit profitability is not as high as that of KURK units: their cost of capital is higher, as it includes both the interest rate paid to savers (roughly 13 percent) and the cost of collecting savings.

The KURK system generates a level of profits not usually found in banking, and this raises some difficult issues. A portion of the profits in KURK units come from start-up subsidies for establishing new units. This is associated with KURK's recent revitalization and ambitious expansion program. In the first year of operation, each KURK unit receives a start-up subsidy from the province to cover salaries. Many of the KURK units were new in 1989, the year shown in Table 4. This source of income will disappear in future years. However, even without it, the KURK units would remain highly profitable. It is questionable whether the salary subsidies are entirely appropriate, or whether they may be too generous.

As the KURK systems expand beyond their equity base, through savings mobilization, profits will decrease. If after this transition is made, in a few years time, profits remain high, it will be appropriate for the KURK system to reduce interest rates on loans and/or to increase salaries. In part, the high profits show that KURK occupies a monopoly within its market niche. Competition is beginning to appear for these systems, and is likely to force profits down during the next decade. The issues of what to do about KURK start-up subsidies and high profits are at this point internal ones for Indonesian policy makers. For other countries, it is astonishing enough to discover that a system based on loans of between \$5 and \$300 could in fact be highly profitable.

Some aspects of the KURK unit cost structure, such as the number of customers served per staff member are likely to be transferable to other countries, and, in fact, are roughly in line with figures from ACCION International programs and the Grameen Bank. However, other aspects, such as the very low salaries, may be difficult to duplicate in countries facing shortages of qualified workers.

Supervision and Ownership

As the preceding discussion has begun to indicate, there are substantial differences in operation and quality of performance between systems in different provinces and between the BPD systems and the BRI Unit Desa system. These differences provide, in effect, a set of controlled experiments. All the BPD systems are based on similar client methodologies and similar unit structures, and as the BRI system is also similar in many fundamentals, most of the differences in their performance are attributable to their supervisory structure and ownership. Examination of the correlation between good performance and good ownership and supervision in these programs shows how essential it is to set

appropriate incentives. Both the service delivery methodology and unit structure are at this point well established, but units will not perform to capacity without a vertical superstructure that can induce the individual units to manage their operations well.

Achievement of responsible performance by financial institutions is difficult in any financial system. The stake held by owners is sufficient to induce most business enterprises to manage their operations profitably and without undue risk. However, in the special case of financial systems, which hold "other peoples money" the incentives of owners are often insufficient; financial institutions are particularly vulnerable to fraud. This introduces the necessity for additional supervision. Thus, in a microenterprise program that has matured into a financial institution, it will be necessary to have internal management structures that motivate good management, and some external supervision to look after the interests of depositors.

From the point of view of internal financial management, the BRI Unit Desa system has significant advantages over the BPD systems. Contrary to some conventional wisdom about BKK and KUPEDES, this advantage arises not because the unit desas serve better-off customers or make larger loans, but because they are all units of a single, well-run financial institution, namely a state-owned bank that functions largely as a private commercial bank. Advantages of this structure include:

- o Attention to the bottom line. Head office has incentive and supervisory mechanism to make sure units are as profitable as possible.
- o Ability to set policy and carry it out. Units operate uniformly. What is taught in training is carried out.
- o Maximizes learning through the system, as the central structure can incorporate lessons from experience or experiments into standard procedures.
- o Freedom from political considerations (relatively) that affect quality of staff hired, policy toward non-payers, and customer selection.
- o Source of liquidity management for units. Also able to intermediate funds both across the country and through time (e.g. dealing with seasonal variation).

These advantages manifest themselves clearly in the steady growth and strong financial performance of the BRI system. Growth targets are consistently met or exceeded. Arrears are kept under control. It is to BRI's credit that it has in the past year been able to correct an upward trend in arrearages. Its monitoring systems were able to identify the problem and its management was able to

influence units to do something about it. BRI has also been able to reduce its operating cost ratios over the years, through careful monitoring combined with continuing efforts to upgrade staff capabilities.

The BPD systems have more complicated ownership and supervision structures, structures which embody serious flaws. The gravest of these is the separation of policy decisions from the monitoring and supervision function. In East and Central Java, the systems are owned by the provincial government. Policy decisions about the systems are made by an interdepartmental committee headed by the planning and coordinating office of the provincial government. However, the provincial development banks (BPDs) are in charge of financial supervision. The BPDs have no ownership stake in the systems, nor do they benefit financially from good performance by the systems and their units.

While the BPDs tend to carry out their duties conscientiously, introduction of appropriate incentives would undoubtedly improve their commitment and effectiveness. The BPDs also lack the authority to carry through their recommendations. On policy matters, they must defer to the interdepartmental committee. The committee tends to favor social, not financial objectives, such as opening as many units as possible and filling staff positions through patronage. This leads to neglect of the fundamentals of financial management. For example, despite clear arrears problems, and repeated advice from technical assistance teams working with the BPD, the BKK system was for several years not allowed to write off its bad debt, the necessary first step in bringing the problem under control.

At the level of specific units, local governments are likely to become involved as well. As governmental entities, the units operate under their auspices. Government officials have significant influence in staff hiring decisions; they tend to be "understanding" about borrowers who do not repay on time; and they have a stake in distribution of profits, some of which are used for local development activities. All of these tendencies undermine good financial management. However, as shown above in the KURK unit structure, profits are so high that the costs of mismanagement are not readily seen. The high interest rate covers a multitude of management errors.

In the system in Bali, units are actually owned by local governments. This poses the most difficult incentive problems for supervision, because the BPD has virtually no leverage over the units. While local autonomy and control is in principle a positive aspect of these systems, it proves unsatisfactory, particularly for systems that are collecting deposits, and must therefore take fiduciary responsibility for that money. Interviews with borrowers confirm that people like to save in locally owned institutions because they trust them and because they believe that in so doing

they are contributing to the community. However, lack of adequate external supervision and the power to enforce it leaves these systems and their depositors highly vulnerable to bad management by the units. As recently demonstrated in the United States, the general public may not learn about the effect of poor management as quickly as it should, and public recognition of a problem that is well-advance can trigger a crisis of confidence leading to collapse. The savings-based systems are vulnerable here.

Bank Indonesia, the nation's central bank, is taking the first steps to classify the BPD system units, and similar private units, as a special category of financial institution, thereby bringing them slowly into the realm of national financial system supervision. Legislation will soon take effect regarding capitalization and other matters. By pursuing this and subsequent steps, Bank Indonesia can itself provide incentives for needed restructuring of ownership and supervision to occur.

PART IV. ORIGINS AND DEVELOPMENT OF THE BRI AND BPD SYSTEMS

Undoubtedly, the historical, cultural and general economic setting established favorable conditions in which these systems could flourish. Some of those conditions have been mentioned above: low salaries for office workers and under-used buildings in the BPD systems, for example. The structure of Indonesian village life supports character-based lending, because engenders a strong sense of community obligation among its members. The Indonesian countryside is very densely populated. This contributes to economies of scale: a large number of borrowers can easily reach each unit. The dense population also means that a high proportion of families must engage in small enterprise activities, as agricultural production on the limited land cannot support their needs. Economic conditions during the 1970s and 1980s were favorable. Indonesia maintained healthy growth rates throughout the period, with a few interruptions, and inflation has been held to easily tolerable levels.

While all these factors may have provided hothouse conditions under which to nurture microenterprise lending systems, they would not have grown without careful tending by government and donors. Extending the analogy, one might expect that the system that emerges in another country will be of a slightly different variety, adapted to local conditions, but that in each case it will be necessary to have an attentive gardener who actively cares for the system. Let us look at how the government and external donors played that role in Indonesia.

The Government of Indonesia has fostered the development of these systems in two quite different ways, both essential. First, it has created the policy conditions that allowed these institutions to develop. Most importantly, it has allowed the systems to charge cost-covering rates on loans and to offer rates to savers sufficient to attract voluntary savings. Secondly, its regulatory policy has not limited the nature of activities which these systems could undertake, which has allowed them to learn through experimentation.

Appropriate policies, while absolutely necessary, were not sufficient conditions to spark the growth of the BPD and BRI systems. The Government of Indonesia also took active sponsorship of these systems. Indeed, all systems are run by governmental institutions operating under central government directives. During the course of the past two decades, there has been continued high level interaction between financial market policy makers and the microenterprise finance institutions. Policy change has not been made in a vacuum, but in response to emerging needs of the systems. The synergy created by this interaction is, perhaps, one of the reasons that what is developing in Indonesia is not just a set of institutions but a complex industry.

These points are illustrated by the specific histories of the BPD and BRI systems. The BPD systems began in the early 1970s as part of a desire by the relatively young Suharto government to win the loyalty of the poor majority. These people had contributed to the political unrest that resulted in an unsuccessful communist coup in 1965 and the fall of the Sukarno regime.⁵ Unlike most politically-motivated efforts to reach the poor, however, (and this is the critical point), the government did not offer to provide a steady stream of subsidies, but rather the means to develop systems that would stand on their own. This choice was made in part out of necessity resulting from funding constraints.

In starting up each of the BPD systems the provincial governments, acting under the general guidance of the central government, made essentially the same offer to localities. They provided a small amount of capital to start up lending programs and told each unit that it must thereafter continue operations through its own earnings. The BKK, for example, was begun in 1972 with a loan to the system from the provincial government of roughly \$500,000. Each unit received a loan of about \$2,500. Over the course of the years, additional inputs have been provided. Additional capital has allowed for new units to be created and for the revitalization of units that had failed.

In the early years of each system, there were a number of failed experiments, due in some cases to lack of qualified management by units and in others to design deficiencies. Revitalization funds have not simply been put in to shore up poorly performing units, but to bring their operations in line with the units and procedures that had proven more successful. For example, in East Java, a system comprised of 1,600 independent two-person posts, begun in 1980, was moribund by 1987. In 1988, capitalization from A.I.D. established the current system of sub-district level units serving village posts, coupled with an improved supervisory structure. This move has been rewarded by stunning growth rates and good financial management. Thus, while the principle of unit self-sufficiency has always held firm, it has been necessary to support a trial and error learning process that has required additional governmental assistance. Once the basic methodology had been established, primarily through the BKK, a spiral effect took hold: when setting up its KUPEDES program, BRI was able to build on the experience of BKK, and now that BRI's system is so strong, the BPD systems are able to learn from it, particularly from BRI's experience with savings.

It was an inspired move by the Government of Indonesia to set up the provincial systems with the clear aim of quickly achieving unit

⁵ Richard H. Patten and Jay K. Rosengard, "Progress with Profits: The Development of Rural Banking in Indonesia," Harvard Institute for International Development, forthcoming.

profitability. Equally bold was the decision to establish the KUPEDES program in BRI. As the state-owned bank charged with serving rural areas, BRI had long administered unprofitable lines of subsidized credit on behalf of the government, using donor funds. Most immediately, it had established a system of subdistrict units, the unit desas, throughout the country to administer BIMAS, a subsidized program which supported rice production on small farms. BIMAS collapsed, and BRI was left with an unprofitable nationwide network of physical and human capital. This same situation faces development banks throughout the third world. However, BRI, unlike most other development banks, responded to this misfortune as an opportunity. At the urging of the Ministry of Finance (and with financial and technical support from A.I.D. and the World Bank) it established the KUPEDES program. KUPEDES (general rural credit) adapted the proven methods of the BKK, including the principles of financially self-sufficient units, full-cost pricing, and (modified) minimalist credit techniques for service delivery. A key policy change, the deregulation of interest rates in 1983, made it possible for BRI to adopt this program. Start up of the KUPEDES program was treated like any other business start up. Break even levels of activity and prices were calculated, and units were given enough start up capital to enable them to get on their feet within three years. The rural market quickly validated BRI's move by applying for KUPEDES loans in droves -- and repaying them.

Throughout the development of the BPD and BRI systems A.I.D. and the World Bank have provided high level technical assistance to various parts of the government of Indonesia, including the Ministry of Finance, the BRI and the BPDs. Because these advisors have been of the highest quality and have remained in Indonesia long enough to win the confidence of important policy makers, they have been able to have a major influence on the development of the programs. The advisors have brought with them sound principles of financial institution development, and have found Indonesian officials to be receptive to them. Crucial principles that the advisors have successfully championed include interest rate deregulation, full cost pricing, financial self-sufficiency of institutions, non-targeting of credit, and most recently, the importance of voluntary savings. These principles have been supported by inputs of funds for capitalization, staff training and physical plant. The advisors kept communications open between the government and donors, so that donor inputs could be precisely tailored to current needs and at the same time could offer the nudge needed to convince the government to move ahead with untested ideas. The technical assistance in development of the BPD and BRI systems is an excellent example of the way policy dialogue should be carried out and the potential benefits of linking policy dialogue and project activities.