CHAPTER ONE

INTRODUCTION

1.1 THE SIGNIFICANCE OF THE STUDY

Microfinance institutions have evolved since the late 1990s as an economic development tool intended to benefit low-income people. Ledgerwood (1999, p.34) points out that the goals of microfinance institutions as development organisations are to service the financial needs of un-served or underserved markets as a means of meeting development objectives such as to create employment, reduce poverty, help existing business grow or diversify their activities, empower women or other disadvantaged population groups (poor people or low-income people), and encourage the development of new business. More specifically, in a World Bank study on lending for small and micro-enterprise projects, three objectives of microfinance institutions are most frequently cited (Webster, Riopelle et al. 1996, p.8): to create employment and income opportunities through the creation and expansion of micro-enterprises, to increase the productivity and incomes of vulnerable groups, especially women and the poor, and to reduce rural families' dependence on drought-prone crops through diversification of their income generating activities. In short, microfinance institutions have been expected to reduce poverty, which is considered as the most important development objective (World Bank 2000). The success of microfinance institutions in achieving their development objectives has been revealed by many studies on that subject since the mid 1990s (Remenyi 1991; Hashemi, Schuler et al. 1996; Khandker 1996; Pitt and Khandker 1996; Hulme and Mosley 1996a; Hulme and Mosley 1996b; Khandker, Samad et al. 1998; Rutherford 1998; Remenyi and Quinones Jr. 2000; Amin, Pierre et al. 2001; Robinson 2001; Robinson 2002; Remenyi 2004).

However, the positive impacts of microfinance institutions on the socio-economic welfare of the poor can only be sustained if the institutions can achieve a good financial and outreach performance. Some studies on microfinance institutions have focused on the assessment of their performance and sustainability by evaluating their financial indicators (such as loan recovery rate and profitability) resulting self-sufficiency, outreach, and delivery mechanism (Riedinger 1994; Yaron 1994; Christen, Rhyne et al. 1995; Chaves and Gonzales-Vega 1996; Yaron, Benjamin et al. 1997; Christen 1998; Yaron, Benjamin et al. 1998; Woolcock 1999). The study of Christen *et al* (1995), for example, analyses the performance – in terms of outreach and financial sustainability - of some microfinance institutions in Bangladesh, Bolivia, Costa Rica, the Dominican Republic, Indonesia, Kenya, Niger, and Senegal. Using consolidated financial data of each microfinance institution, this study focuses on several performance indicators such as loan size, number of borrowers, operational self-sufficiency, financial self-sufficiency, adjusted return on assets (ROA), and adjusted return on equity (ROE). The findings of Christen *et al* suggest that the two keys to full self-sufficiency are efficient operations and appropriate pricing policies. However, this study does not reveal the influence of institutions[1] – both formal and informal institutions - on those financial performance indicators.

Another study, conducted by Chaves and Gonzales-Vega (1996), reveals the success of microfinance institutions in Indonesia as an effect of the organisational design. They argue that the design of an organisation that will supply financial intermediation services is vital because this will determine its performance and, hence, the success or failure of the institution. This study also reveals that the Village Credit Institution (LPD) of Bali has already incorporated village agents into their credit delivery systems – the so-called character-based lending technique. Moreover, Chaves and Gonzales-

[1] The World Bank (2002) defines institutions as the rules or procedures that shape how agents (people) interact and the organizations that implement the rules and codes of conduct to achieve desired outcomes. Institutions are classified in two types which are formal and informal institutions. Formal institutions include the rules written into the law and regulations by government, rules codified and adopted by private institutions, and public and private organizations operating under public law. Informal institutions, which often are operating outside the formal legal system, reflect unwritten codes of social conduct such as social norms and sanctions.

Vega also point out that character-based lending and local monitoring have been comparatively efficient in avoiding costly mistakes in assessing the probability of loan repayment. However, their study does not specifically analyse the influence of institutions on the performance and sustainability of the LPDs. This study only analyses the general features of eight microfinance institutions (such as LPD, BKK, BKD, and KURK) simultaneously using consolidated financial data of the institutions at provincial level.

A third example is the study by Yaron (1994) that reviews the policies, modes of operation, incentives, and financial performance of four publicly sponsored microfinance institutions in Asia – the Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand, the BKK and the BRI Unit Desa in Indonesia, and the Grameen Bank in Bangladesh – that are perceived to be successful, to find out what economic, social, and institutional factors contributed to their success. Yaron (1994) identifies four necessary conditions for a microfinance institution to become sustainable. First, the institution has to have positive on-lending interest rates high enough to cover non-subsidised financial costs (for a subsidised institution) to maintain the value of equity in real terms. Second, the institution has to achieve a high repayment rate. Third, the institution has to offer deposit interest rates high enough to ensure the voluntary saving becomes increasingly significant in financing the loan portfolio. Lastly, the institution must be efficient (including low transaction and administrative costs) in its delivery mechanism which includes the screening process, processing loans, collecting repayments, and mobilising and servicing savings to ensure that lending rates do not become prohibitive. Using consolidated financial data at provincial level and descriptive analysis, this study also identifies the important role of social mechanisms in the success of the institutions studied.

Concerning the level of sustainability, Christen *et al* (1995) divide the level of sustainability into three categories. The first category comprises institutions in which revenues from interest and fees do not cover operating costs. Microfinance institutions in this category are heavily dependent on subsidies in the form of grants or low-interest

loans from donors or governments. Robinson (2001) argues that most of the world's microfinance institutions are categorised in the first category. The second category identifies institutions in which revenue covers operating costs but does not cover the commercial costs of loanable funds. This second category refers to microfinance institutions in which fees and interest charges cover nonfinancial costs, but still depend on subsidies to varying degrees for the cost of loanable funds. Fully self-sufficient institutions that cover all costs and risks and generate profit are in the third category which refers to microfinance institutions whose revenues cover both nonfinancial and financial costs calculated on a commercial basis. The Village Credit Institution of Bali (Lembaga Perkreditan Desa or LPD) is one of very few examples of microfinance institutions in this category (Robinson 2001, p.57).

The sustainability of microfinance institutions as described above, however, cannot be achieved if the institutions do not meet the needs of the people that they are designed to help (Snow 1999). Snow (1999) points out that sustainable microfinance institution must be embedded in, and linked with, the network of existing local institutions. Hence, sustainability must be socially constructed, that is, arrangements of a social and economic nature must be made purposively (Cernea 1993). Cernea (1993, p.12) reveals that over half (13 projects) of 25 World Bank projects in Africa, Asia, and Latin America had left no lasting developmental impact 6-10 years after completion and had failed to produce the expected flow of benefits. Cernea (1993) emphasises that among the basic causes of nonsustainability were the neglect of sociological factors – such as social action, the relationships among people, their institutional arrangements, culture, motives, values that regulate their behaviour - in project design and the lack of supportive institutions and grassroots participation. In sum, the social content of sustainability was missing. On the contrary, all the projects that proved to be sustainable undertook purposive institution building from the beginning. This study then intends to reveal the role of those sociological factors on the sustainability of microfinance institutions.

In addition, from the strategic management perspective several studies have also revealed that the sustainability of a firm has been very much influenced by their

institutional environments, both formal and informal institutions (Meyer and Rowan 1977; DiMaggio and Powell 1983; Baum and Oliver 1991; Carrol 1993; Oliver 1997). These scholars argue that an organisation's life chances are significantly improved by organisational demonstrations of conformity to the norms and social expectations of the institutional environment. Further, they also point out that when an organisation develops ties to well-established societal institutions (informal institutions), it signals its adherence to institutional prescriptions of appropriate conduct and obtains a variety of rewards that are predicted to contribute to its likelihood of survival, including enhanced legitimacy, and status, greater stability and predictability, and greater ease of access to resources.

These studies on microfinance institutions' sustainability, however, do not focus on the role of institutional environment in which the microfinance institutions operate, for instance, the linkages between microfinance institutions and local institutions (such as regional government), and/or relationships between informal institutions (including social custom, values, and norms) and formal institutions (formal legal system such as government regulations) that could affect the sustainability of the microfinance institutions. Snow (1999, p.66) points out that these issues receive little attention from scholars, despite the fact that the institutional environment is a key factor affecting sustainability, and is especially important for those who wish to replicate a microfinance institution scheme. Therefore, this study will focus on the role of institutional environment on the performance and sustainability of a microfinance institution.

Two main differences distinguish this study from previous studies. First, this study focuses, as mentioned earlier, on the linkages between microfinance institutions and local institutions (such as regional government and custom village), the relationship between informal institutions (including social custom, values, and norms) and formal institutions (formal legal system such as government regulations), and the influence of the informal and formal institutions on the performance and sustainability of the microfinance institutions. Second, this study adopts different methodological tools. Previous studies mentioned earlier – such as Yaron (1994), Christen *et al* (1995),

Chaves and Gonzales-Vega (1996), and Yaron *et al* (1998) – use a multiple case study approach that analyses several microfinance institutions, while this study uses the single case study approach. The use of a single case study approach allows us to capture the complex phenomenon of the microfinance institution which is very closely related to its socio-cultural environment, by triangulating different research approaches, methods, and techniques to study the same phenomenon in a single study. It also interprets the findings within existing theory concerning the factors affecting the sustainability of a microfinance institution, to understand and explain what is happening to one particular microfinance institution (Denzin 1978). The intention of this study, however, is not to test theory or to develop new theoretical explanations, but to understand intrinsic aspects of the institution more thoroughly and its related context such as the role of civil society institutions and their connection to microfinance institutions. In doing so this case study will offer some new insights into theoretical issues that have concerned researchers of microfinance institutions, such as how informal institutions deal with the problem of asymmetric information in the rural credit market. In considering this research problem, the single case study approach is appropriate as it offers the researcher the opportunity to study the complex phenomenon of the socio-cultural embeddedness of microfinance institutions that is still little understood.

In terms of the unit of analysis, referring to Yin's (2003) classification of case study design, most previous studies use a holistic case study design which examines only the global nature of an organisation (in this case a microfinance institution) and uses consolidated financial data of the selected microfinance institutions at provincial level. This design is advantageous when no logical subunits can be identified or when the relevant theory underlying the case study is itself of a holistic nature (Yin 2003, p.45). Yin argues, however, that potential problems arise when a global approach allows a researcher to avoid examining any specific phenomenon in operational detail. One way to capture a specific phenomenon in operational detail is to have a set of subunits of analysis. This study, accordingly, applies an embedded case study design since this design, as argued by Yin (2003, p.45), can serve as an important device for focusing a

case study inquiry. At the first level, this study assesses the performance and sustainability of the LPDs and the affecting factors at the district level and, at the second level, it assesses the performance and sustainability of the LPD at firm (unit) level in order to better understand the factors affecting its performance and sustainability and learn some lessons from the LPD experience. Yin (2003) also argues that this case study design can add opportunities for extensive analysis and enhance the insights into the single case. This case study design is elaborated in Chapter 5 on Research Methodology.

1.2 MICROFINANCE AND MSEs DEVELOPMENT IN INDONESIA

Ledgerwood (1999, p.1) defines microfinance as the provision of financial services to low-income clients including small traders, street vendors, small farmers, service providers (hairdressers, rickshaw drivers), artisans and small producers. These clients are often classified as micro and small-scale enterprises (MSEs). The statistical definition of MSEs varies by countries, and is usually based on the number of employees or the value of assets. The Central Bureau of Statistics of Indonesia (CBS of Indonesia) defines small-scale industries as establishments that employ 5 to 19 workers, while micro/cottage (home) industries employ fewer than 5 workers per establishment, including unpaid family workers (The CBS of Indonesia, 1996). In other developing countries, MSEs are generally defined as establishments that employ 1 to 50 workers (see for example: Daniels, 1999, p.56; Mead & Liedholm, 1998, p. 62; Mead, 1994, p.1883). In developed countries, such as Australia, the Australian Bureau of Statistics (ABS) defines small non-agricultural businesses as manufacturing industry business with fewer than 100 employees or non-manufacturing industry businesses with fewer than 20 employees (see (Forsaith, Fuller et al. 1995, p.110). They are mostly dependent on microfinance institutions as the source of capital, especially operating capital. Many studies undertaken since the 1980s have revealed this relationship, for instance, Cole and Park (1983), Ghate (1992a), Ghate (1992b), Izumida (1992), Tang (1995), and Kan (2000). This section briefly describes the role of

MSEs in economic development in developing countries, their relation with microfinance institutions, and the particular constraints faced the MSEs in Indonesia.

As widely known, micro and small-scale enterprises (MSEs) have an important role as a major source of employment and income in developing countries (Mead 1994; Mead and Liedholm 1998; Daniels 1999). In Indonesia, several studies (Wie 1992; Sandee, Rietveld et al. 1994; Sandee, Andadari et al. 2000; Berry, Rodriguez et al. 2001; Hill 2001; Rice 2003) also reveal the importance of MSEs in the Indonesian economy. The studies argue that MSEs are not very important in terms of total value-added but are very important in employment generation. From the political perspective, Hill (2001) points out that MSEs are a clear and consistently enunciated Indonesian government priority. They feature prominently in key government documents, such as five-year-plans (Repelita), the broad outlines of Government Policy (GBHN), and many official statements (Hill 2001, 248). This support has also manifested itself in a separate ministry for MSEs (together with cooperatives) established in 1993. Moreover, it is also argued that the MSEs in Indonesia are of significant importance as they are seen as a vehicle for promoting indigenous Indonesian (*pribumi*) business and therefore as a means of asset redistribution along ethnic lines (Berry, Rodriguez et al. 2001, p. 377; Hill 2001, p. 240).

Table 1.1 Micro, Small, Medium, and Large Enterprises in Indonesia, 1999-2003

	1999		2001		2003	
		%		%		%
Number of establishments:						
Micro and Small	2,866,003	99.2	2,196,899	97.3	2,577,075	97.5
Medium and Large	22,997	0.8	59,838	2.7	64,229	2.5
Number of employees:						
Micro and Small	59,939,760	88.75	65,134,223	89.17	70,282,178	88.43
Medium and Large	7,597,562	11.25	7,912,074	10.83	9,192,813	11.56
Value added at constant price 1993 (Rp. Million):	156,721,479	41.31	168,832,118	41.0	183,125,803	41.2
Micro and Small	222,630,924	58.69	242,921,366	59.0	261,327,671	58.8

Medium and Large						

Source: Ministry of Cooperatives and Small and Medium Enterprises Development (2004)

Using the BPS criterion of what constitutes MSEs, Table 1.1 shows the relative importance of MSEs in Indonesian economy. Table 1.1 clearly shows on the average there are disparities in productivity between medium -and large-scale enterprises on the one hand and MSEs on the other hand. The medium and large-scale establishments constitute only 1 percent of the total number of enterprises, but they produced 58.69 percent of total value-added in 1999. In terms of employment generation, however, MSEs were important, accounting for more than 88 percent of total employment in the period 1999-2003.

In addition to employment creation, the importance of MSEs is also based on socio-economic arguments (Wie 1992). The arguments include the need to develop a wide base of small but dynamics entrepreneurs, the need to spread economic activities away from the big urban agglomerations, and the need to develop small firms which are often more flexible in responding to fast changing economic and technological developments. In Indonesia, the promotion of MSEs takes on great importance as these industries constitute a good training ground for the development of indigenous entrepreneurs and of skilled industrial workers. That small entrepreneurs are able to build up viable, dynamic enterprises is evident from the examples of Hong Kong and Taiwan. Another socio-economic argument is the need for a greater geographic dispersion of economic activities to reduce the pronounced industrial concentration in urban agglomerations. Wie (1992) argues that this argument is certainly valid for Indonesia, where most of the large manufacturing plants are located on Java, particularly in the Jakarta metropolitan region and the adjacent regions in West Java, and in Surabaya. As MSEs are located all over the country, the promotion of these MSEs will also promote a geographically more even distribution of industrial activities (Wie, 1992).

Others scholars argue that the small-scale enterprises could serve as the seedbed of industrialization through two possible mechanisms, graduation of small-scale enterprises and savings by microentrepreneurs (Weijland 1992; Grosh and Somolekae 1996). Small-scale enterprises could graduate to become larger and the owners of the small-scale enterprises could accumulate capital that might be used by next generation entrepreneurs to start larger businesses. Grosh and Somolekae (1996) propose three policy approaches to fostering such enterprises. First, the policy approach at the level of the firm can form on-factors such as increasing access to capital, provision of business training of the entrepreneurs, and facilities improvement such as provision of industrial estates that were supposed to play an incubator role. Second, it is suggested that the macroeconomic policy can form on-factors such as financial reforms and improvement of tariff structure and foreign exchange policies. Recent reforms have addressed the financial sector, where usury ceilings that create low or negative real interest rates resulted in credit rationing, a condition that particularly hurts new or small enterprises, which will be bypassed by banks in favour of established formal sector borrowers. Tariff structure and foreign exchange policies may also penalize MSEs since many MSEs' inputs (for example, sewing machines) are classified as consumer goods. The structure of protection often involves high duties on consumer goods and low duties on intermediate and capital goods, so small firms end up paying higher duties on their inputs than larger firms. Finally, it is also suggested that legal/institutional/bureaucratic framework approaches should be taken in order to facilitate a favourable environment for MSEs such as changes in the land tenure system, improvement in the system of licensing and regulating financial institutions including establishment of deposit insurance, prudential regulation, and bank examination.

For the case of Indonesia, it is argued that geographically clustered MSEs may have a seedbed function for industrial development (Weijland 1992). Clustering policy has brought about some success in areas such as poverty alleviation and industrial development. If judged by the capacities of individual enterprises, rural MSEs have little strength, but it is argued that through the development of trade networks and

clusters many of the marketing and technology problems can be resolved. Pooling production reduces the transaction costs of purchasing inputs and marketing outputs, and therefore attracts traders. Clustering also eases information flows and facilitates order-sharing, labour-sharing and subcontracting. For the more advanced clusters, technology aspects grow increasingly important the more expensive equipment and special skills could be shared. Savings and loan associations contribute to solving financial problems, and, although formal cooperatives are not popular, they sometimes help people to gain access to technical assistance and formal credit. Weijland (1999, p. 1519) shows several studies revealing the success of clustering as a seedbed function in Indonesia, for instance: a roof tile cluster, metal casting, and textile weaving in Central Java.

However, there have been some constraints on micro and small-scale enterprise (MSEs) growth and development and one of the most important constraints is the lack of access to finance (Schmitz 1982; Anderson and Khambata 1985; Remenyi 1991; Levy 1993; Morewagae, Seemule et al. 1995). This is the leading constraint to MSE's growth and development since commercial or formal financial institutions are reluctant to grant them loans. There are at least three reasons why formal financial institutions are reluctant to lend loans to the MSEs. First, based on his study of small-scale manufacturing in developing countries, Schmitz (1982) points out that the formal financial institutions consider the security offered by small producers is inadequate. This happens because of the unstable and risky conditions of production of small producers that could cause repayment defaults. Second, the controls on interest rates and on the borrowings and lendings of financial intermediaries in most developing countries, apart from limiting capacities of the intermediaries to raise resources, have necessarily led them to concentrate their lending on low-risk, large-scale, and corporate borrowers. In consequence, large numbers of efficient small-scale activities, which employ the majority of the labour force in most developing countries, do not have access to institutional finance (Anderson and Khambata 1985). Third, incentives for formal finance institutions (commercial banks) to lend to MSEs are weak (Levy 1993). Since loan sizes are small, the costs of processing are high in relation to loan amounts.

Moreover, the track record and reputation of a putative MSE borrower is likely to be limited, which adds to the costs of loan processing. The probability of failure is high even for well-conceived new ventures. This lack of access to finance is also faced by MSEs in Indonesia since the majority have received neither technical nor financial assistance (Berry, Rodriguez et al. 2001, p. 378).

Moregawe *et al* (1995) point out that the problem of access to credit is exacerbated by the fact that the majority of the small-scale enterprises are run by people who either have no education or, in the main, attained only a few years of primary education. Moregawe *et al* (1995, p.484) argue that "it is unlikely that people of this calibre would have the courage to approach lending institutions for financial assistance". Moregawe *et al* (1995, p.484) suggest that "if the lack of schooling factors hold, there is a need to facilitate increased access by low-income households to credit available".

Table 1.2 Number of Establishments of Small-scale Manufacturing Industry in Bali Province by Source of Capital Ownership, 1996

Source of capital ownership	Establishment	
	Number of establishment	%
No use of loan facility	3,343	61.9
Use loan facility	2,054	38.1
▪ Bank	(1,104)	(20.4)
▪ Cooperative	(143)	(2.6)
▪ Non-bank Financial Institutions	(192)	(3.5)
▪ Others	(615)	(11.6)
Total	5,397	100.00

Source: BPS-Statistics Indonesia, *Small Scale Manufacturing Industry Statistics 1996*, 2000

In Bali province, as shown Table 1.2, there were 5,397 small-scale industries establishments which had 43,163 employees in 1996 (CBS of Indonesia 2000). Most of the establishments are manufacturers of woods and wood products (including furniture) and wearing apparel and leather industries. The wood manufacturing and wearing apparel and leather industries are 36 percent and 23 percent of the establishments

respectively. These two industries absorbed more than 50 percent of employment in small-scale industries. In Bali, most small-scale industries (61.9 percent of establishments) do not use loan facilities and only 20.4 percent use loans from a bank. Even though the government of Indonesia has launched a credit scheme in the form of Small-scale Business Credit (Kredit Usaha Kecil or KUK), this credit scheme only reaches a small proportion of small-scale enterprises in rural areas (CBS of Indonesia 2000). From 1992 up until 2001, more than 50 percent of the KUK credit went to Bali's urban areas (particularly the city of Denpasar and Badung district). This indicates a need, especially in rural areas, to enhance the development of sustainable microfinance institutions, such as the LPDs, which provide credit with simple procedures and easy access for low-income people such as small-scale entrepreneurs. Hence, this study aims to explore how microfinance institutions work currently in rural areas in Bali in order to take some lessons, as mentioned earlier, from the institutions studied that can be applied for developing and enhancing the development of sustainable microfinance institutions in other parts of Indonesia.

In the literature, there has been a debate between two approaches concerning the best way to help low-income people such as small-scale entrepreneurs through access to financial services provided by the institutions (Woller, Dunford et al. 1999; Morduch 2000). The first is the institutionist approach. This approach focuses on creating financial institutions to serve clients who either are not served or are underserved by the formal financial system (i.e. the commercial banks). The goal of this approach is to achieve institutional self-sufficiency through achieving financial self-sufficiency, breadth and depth of outreach, and positive client impacts. The central focus of this approach is the institution, and institutional success is generally gauged by the institution's progress toward achieving financial self-sufficiency. The institutionists argue that a primary objective of microfinance is financial deepening, that is, creating a separate system of sustainable financial intermediation for the poor. Theirs is a "financial systems" approach to microfinance in which the future of microfinance is dominated by numerous large-scale, profit-seeking institutions that provide high quality financial services to large numbers of poor clients. The institutionists eschew subsidies

of any kind, because they insist on financial self-sufficiency. This approach is rooted in the Ohio School of thought on microfinance (Hulme and Mosley 1996a).[2] According to Woller *et al* (1999), the best-known examples of the institutionist approach are Bank Rakyat Indonesia (BRI), Banco Solidarion (BancoSol) in Bolivia, and the Association for Social Advancement (ASA) in Bangladesh.

The second approach is welfarist. This approach focuses on reducing poverty through credit, often provided together with complementary services such as skills training and teaching of literacy and numeracy, health, nutrition, family planning, and the like (Ledgerwood 1999, p. 63; Robinson 2001, p. 22). Robinson (2001) points out that under this approach credit is provided to poor borrowers, typically at below market interest rates. The goal is to reach the poor, especially the extremely poor - the poorest of the poor - with credit to help overcome poverty and gain empowerment. Thus, the welfarists are quite explicit in their focus on immediately improving the well-being of participants. Woller *et al* (1999) point out that the welfarists are less interested in banking *per se* than in using financial services as a means to alleviate directly the worst effect of deep poverty among participants and communities, even if some of these services require subsidies. Their objective tends to be self-employment of the poorer of the economically active poor, especially women, whose control of modest increases of income and savings is assumed to empower them to improve the conditions of life for themselves and their children. The centre of attention is the "family". Woller *et al* (1999) point out that like the institutionists, welfarists have assumed more impact on poverty alleviation than they actually have been able to document. The most prominent examples of welfarist institutions are the Grameen Bank in Bangladesh and its replicas elsewhere, and FINCA (Foundation for International Community Assistance) village banking model in Latin America and, more recently, in Africa and Asia (Woller, Dunford et al. 1999).

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[2] The best known members of the Ohio School are Dale Adams, Carlos Cuevas, Gordon Donald, Claudio Gonzales-Vega, and J. D. von Pischke, the last of these based until recently in the World Bank rather than in academe and as such a crucial conduit for the transmission of the School's ideas into the Bank's operational practice.

In practice, Robinson (2001) notes that the two approaches have substantially contributed to the development of institutional microfinance. Some institutions using the welfarist approach have successfully reached poor people with donor- and government-subsidised credit services. This approach seems to be more suitable for the poorest of the poor. However, the successful institutions following the welfarist approach, in aggregate, can meet only a small portion of the demand for microfinance since most institutions following this approach (subsidised credit) are not sustainable (Robinson 2001, p.23, p. 140-8). In contrast, the institutionist approach has proven that it is able to make financial services –both credit and savings- available to low-income clients on a large scale, and to do so profitably and sustainably. Institutions such as BRI *Unit Desa System* and BancoSol have demonstrated that broad outreach to economically active poor clients can be achieved without ongoing subsidies. Therefore, Robinson – as a proponent of the institutionist approach - argues that serving millions of clients on a long-term basis in multiple, competing institutions requires a financial system approach or institutionist approach (Robinson 2001, p.23).

Microfinance institutions and programs in Indonesia can also be classified based on the two approaches. However, according to some scholars (Bolnick 1988; Riedinger 1994; Yaron 1994; Chaves and Gonzales-Vega 1996; Ravicz 1998; Woller, Dunford et al. 1999; Conroy 2000; Lapenu 2001; Robinson 2001; Meagher 2002; Robinson 2002), most Indonesian microfinance institutions follow the institutionist approach or are intended to support financial deepening. Some good examples are: BRI *Unit Desa System*, BPR (People's Credit Bank), and non-bank financial institutions such as Village Credit Institutions (*Lembaga Perkreditan Desa* or LPD) in Bali, Sub-districts Credit Institutions (*Badan Kredit Kecamatan* or BKK) in Central Java, and Rural Credit Institutions (*Badan Kredit Desa* or BKD) in Java and Madura. Their primary objective is financial deepening and the creation of a separate system of sustainable financial intermediation for the poor.

On the other hand, there are also some microfinance programs following the welfarist approach such as *Kredit Usaha Tani* (credit for agricultural activities) Program - which

provides subsidised credit for farmers - and *Kredit Usaha Kecil* (credit for small-scale enterprises) Program. Other examples were the Presidential Instruction on Backward Villages Program (*Program Inpres Desa Tertinggal* or IDT) launched in 1993 and the Prosperous Family Program (*Program Keluarga Sejahtera* or PKS) launched in 1996. These two credit schemes were initiated by the Government of Indonesia, and their institutional sustainability was not an objective since the program was only an emergency response to political concerns about income inequality at that time (McGuire, Conroy et al. 1998; Conroy 2000). These two credit schemes are discussed in more detail in Chapter 3.

Since the centre of attention of this study is Village Credit Institution of Bali (Lembaga Perkreditan Desa or LPD) and the factors affecting its self-sufficiency (sustainability) through assessing its financial performance and outreach indicators, this study follows the first approach. The performance indicators assessed include its portfolio quality, leverage and capital adequacy, productivity and efficiency, profitability, financial viability, and outreach.

1.3 OBJECTIVES OF THE STUDY AND RESEARCH QUESTIONS

This study has three main objectives. The first is to assess the influences of informal and formal institutions and their interrelationships on the practical operational arrangement of microfinance institution that, in turn, will influence the financial performance and outreach indicators. As noted earlier, the previous studies on the performance of microfinance institution do not focus on the institutional environment of microfinance institutions such as the relationship between microfinance institutions and local institutions (such as regional government and commercial banks), the relationship between informal institutions and formal institutions (formal legal system), and their influences on the practical arrangement of microfinance institutions, despite the fact that the institutional environment are a key factor affecting the sustainability and especially important for those who wish to replicate a microfinance institution scheme as argued by Snow (1999).

The second is to evaluate the financial performance and outreach indicators of Village Credit Institutions of Bali (Lembaga Perkreditan Desa or LPD) and to assess the influence of informal and formal institution on the financial performance and outreach of microfinance institutions which receive little attention, as mentioned earlier, from scholars. This is important because a good financial performance and outreach indicators are the necessary condition for the sustainability of a microfinance institution. The performance indicators used in this study are described in the literature review chapter (Chapter 2, section 2.5) and methodology chapter (Chapter 5, section 5.4) of this thesis. This study will not deal with the impact of microfinance institutions on poverty. The focus of is on the evaluation of financial performance and outreach of microfinance institutions being studied.

Having evaluated the financial and outreach performance and assessed the influences of the institutional environment and their impact on the practical operational arrangement of microfinance institution, this study comes to the third objective. This is to outline some elements of a strategic business plan for two village credit institutions (LPDs) in Gianyar district, LPD Mas and LPD Kerta. The LPD Mas is located in the small-scale industries (handicrafts) based village and the LPD Kerta is located in the agricultural based village. The reasons why these two LPDs were selected are explained in Chapter 5 (Research Methodology). As known, the process of creating a strategic business plan – the so-called strategic planning – involves three activities that are strategy formulation, strategy implementation, and strategy evaluation (David 2001, p.5-6). Strategy formulation is the focus of the strategic planning activities in this study since the last two activities – strategy implementation and strategy evaluation - are beyond the scope of the present study. The strategy formulation activity includes defining the enterprise's mission, specifying achievable objectives, and developing strategies (some elements of the business plan). Theoretically, the aim of creating a strategic business plan is to improve on how an enterprise is operating today and the need for action to prepare for the future markets and changing environment conditions (Thompson and Strickland III 2001, p.16). Practically, the creation of some elements of

a strategic business plan in this study is expected to have some benefits for the future development and sustainability of the LPDs. The SWOT (strengths, weaknesses, opportunities, and threats) analysis used to achieve this objective will strengthen and sharpen the previous analyses to achieve the first and second objectives.

The summary of research questions I intend to address include:

1. What are the influences of formal institutions on the practical operational arrangement of the LPDs?
2. What are the influences of informal institutions including social custom, values, and norms on the practical operational arrangement of the LPDs?
3. What is the relationship between the formal institutions and the informal institutions in regard to their influences on the practical operational arrangement of the LPDs; and what are the roles of the Central Bank, commercial banks, and local government on the practical operational arrangement of the LPDs?
4. What is the financial and outreach performance of the Village Credit Institutions (*Lembaga Perkreditan Desa* or LPD)? Is there any influence of informal and formal institutions on the performance, and is there any difference in performance between the LPDs located in the handicraft-based economy on the one hand, and the agricultural-based economy on the other?
5. What are the strengths and weaknesses of LPDs and what are opportunities and threats faced by LPDs in the future, in order to outline some elements of business plans for the selected LPDs?

1.4 ORGANISATION OF THE THESIS

The remainder of this thesis is divided into eight chapters. Chapter 2 deals with the nature of microfinance institutions from some theoretical perspectives. The first part of the chapter introduces the definition and characteristics of microfinance institutions. The second part reveals the role of microfinance as a financial intermediary and its relationship with the commercial banks, whether they are complementary or substitutive. The third part discusses some theories on the relationship between risk

problems and the rural credit market, and the role of institutions - especially informal institutions - in overcoming the risk problem in the rural credit market in developing countries. A review of some performance measurement approaches of microfinance institutions and the adopted approach in this study are presented. Chapter 3 of the thesis presents the general setting of microfinance institution development in Indonesia in order to understand the position of the LPD in the context of the microfinance institution development, and the evolution of the Indonesian regulatory and legislative framework on microfinance institution development.

As socio-economic characteristics of an environment have been the important factors of the success of microfinance institution and a firm in general (Meyer and Rowan 1977; DiMaggio and Powell 1983; Baum and Oliver 1991; Rhyne and Otero 1992; Carrol 1993; Chaves and Gonzales-Vega 1996; Oliver 1997), an investigation of the socio-economic environment of Bali province in which the LPD operates is indispensable. As known, Bali has a unique culture and social institutions because of its socio-cultural aspects that are rooted in two basic interrelated systems: (a) the extended family, community (*banjar*) and the ancestor systems, and (b) the Balinese Hindu religion (Jensen and Suryani 1992). Therefore, the economic and socio-cultural environments surrounding the LPD are presented in Chapter 4, including geographic and demographic conditions, government administration system and some regulations, socio-cultural aspects, and the economic situation of Bali province. This is followed in Chapter 5 by an outline of the research methodology. This chapter describes the research paradigms adopted in this study and the use of triangulation, and the underlying reason why a case study strategy is adopted. In addition, this chapter also describes the specific research procedures including the selection of the type of case study used, the fieldwork conducted, including data collection (through collection of documentary information, archival records, and interview), and methods and tools of analysis that use the triangulation technique by using quantitative and qualitative methods of data collection and analysis.

The heart of the thesis lies in Chapters 6, 7 and 8. Chapter 6 contains an institutional analysis which emphasises the influence of formal institutions (formal legal regulations), informal institutions (culture, social norms, social values, and social sanctions), and interactions between those two types of institutions on the practical operational arrangements of the LPD. The main findings contained in this chapter have been published in the *Journal of Indonesian Economy and Business* (Arsyad 2005). Chapter 7 analyses the financial and outreach performance of LPDs in general and the LPDs located in handicraft-based subdistricts and agricultural-based subdistricts in Gianyar district of Bali and asseses the influence of informal and formal institutions on the financial and outreach performance. Specifically, the financial performance indicators include portfolio quality, leverage, capital adequacy ratio, productivity, efficiency, profitability, and financial viability of the LPD. The outreach indicators cover clients and staff outreach, loan outreach and saving/deposits outreach. The outreach indicators can be used as the proxy for the microfinance impact on economic development. It is argued that the use of financial indicators to assess the success of the microfinance institution is not sufficient (Yaron 1994; Chaves and Gonzales-Vega 1996; Yaron, Benjamin et al. 1998). In short, the main purpose of analysing the financial and outreach performance of the LPD is to assess the health of the LPD as a financial institution based on prudential principles of banking operations, including CAMEL (Capital Adequacy Ratio, Assets quality, Management, Earnings, and Liquidity). Meanwhile, the comparison of the two microfinance institutions located in different economic-based regions aims to examine whether or not the economic-base of a region has a different and significant effect on the financial performance of the LPD. A shorter version of the discussion in Chapter 7 has been published in the *Gadjah Mada International Journal of Business* (Arsyad 2005b).

It is argued that the use of financial indicators to assess the success of microfinance institutions is not sufficient (Yaron 1994; Chaves and Gonzales-Vega 1996; Yaron, Benjamin et al. 1998). These scholars use outreach as an additional indicator which can also be used as the proxy of microfinance impact on economic development. The outreach indicators cover clients and staff outreach, loan outreach and saving/deposits

outreach. Moreover, chapter 7 also attempts to examine the factors affecting the performance and sustainability of the LPD. Based on the findings in Chapters 6 and 7, and using SWOT analysis, Chapter 8 then outlines elements of strategic business plans for the two LPDs which include their mission statement, objectives, and strategies. The final chapter concludes the thesis by drawing together the various threads running through the chapters with a view to answer the basic question of this thesis – what makes the LPDs sustainable? In answering this question the concluding chapter summarises what is distinctive about microfinance institutions in Bali, and how the findings of this thesis can be applied to improve our understanding of microfinance institutions in other parts of Indonesia.

CHAPTER TWO

MICROFINANCE, INSTITUTIONS, AND PERFORMANCE: A LITERATURE REVIEW

2.1 INTRODUCTION

A microfinance institution is generally characterised by a collage of dynamic, innovative, and flexible arrangements that are tailored to the local economic and social environment (Adams and Fitchett 1992). Microfinance institutions are a complex phenomenon that has economic and socio-cultural dimensions. This chapter describes the nature of microfinance institutions in order to assess the factors affecting their performance and sustainability. The first part of this chapter introduces the definition, characteristics, and practical arrangement of microfinance institutions in developing countries. As mentioned above, this will help us to understand the basic nature of microfinance institutions as the object of this study. The second section discusses the importance of microfinance institutions as financial intermediaries based on experiences of some developing countries. This discussion aims to reveal their relationship with the commercial banks - complementary or substitute - that might have some influences on the sustainability of microfinance institutions. The third part discusses some theories on the relationship between risk problem and the rural credit market, and the role of institutions, especially informal institutions, in overcoming the risk problem in the rural credit market in developing countries. It thus gets to one of the key themes of this study and sets the scene for an analysis later in the thesis of the factors affecting the performance and sustainability of Village Credit Institutions of Bali (*Lembaga Perkreditan Desa* or LPD) in relation to its institutional environment, both formal and informal institutions. The financial performance and sustainability of microfinance institutions will be reviewed in the last section. This part also begins to

address the concerns of this thesis by outlining its approach in assessing the performance and sustainability.

2.2 DEFINITION AND CHARACTERISTICS OF MICROFINANCE INSTITUTIONS

The definitions of microfinance institutions proposed by some scholars and organisations are seemingly different from one another. However, the essence of the definitions is usually the same in which microfinance refers to the provision of financial services, primarily savings and credit, but also other financial services to poor and low-income households that do not have access to commercial banks.

Ledgerwood (1999, p.1) states in her *Microfinance Handbook,* published by the World Bank, that the term microfinance refers to the provision of financial services (generally savings and credit) to low-income clients. The clients are often identified as traders, street vendors, small farmers, service providers (hairdressers, rickshaw drivers), and artisans and small producers, such as blacksmiths and seamstresses. She points out that many such clients have a stable source of income since they have multiple sources of income. Although they are poor, they are generally not considered to be “the poorest of the poor”.

The Asian Development Bank (ADB) defines microfinance as the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and their micro-enterprises (ADB 2000, p.6). The ADB definition includes low income households as well as those below the poverty line since there are a significant number of low-income households that are not below the poverty line, but have limited access to financial services, especially in rural areas.

Robinson (2001, p.9) points out that the term microfinance refers to “small-scale financial services, primarily credit and savings, provided to people who farm or fish or

herd; who operate small enterprises or micro-enterprises where goods are produced, recycled, repaired, or sold; who provide services; who work for wages and commissions; who gain income from renting out small amounts of land, vehicles, draft animals, or machinery and tools; and other individuals and groups at the local levels of developing countries, both rural and urban area." A slightly different definition is formulated by Meagher (2002). He suggests that microfinance is lending small amounts of money for short periods with frequent repayments (Meagher 2002, p.7). Concerning the definition of microfinance institution, he argues that as a general principle, it is important to provide a definition that will enable market participants to be responsible, energetic, and innovative. The legal definition should be broad enough both to enable a focus on a sensible target group and to provide a wide range of appropriate financial services for that group.

In practice, in addition to financial intermediation, some microfinance institutions provide social intermediation services such as group formation, development of self-confidence, and training in financial literacy and management capabilities among members of a group intended to benefit low-income women and men (Bennett 1998; Ledgerwood 1999). Part of the reason is that low-income people face strong barriers (such as illiteracy, gender discrimination, and remoteness) in trying to gain access to ordinary financial service institutions (Ledgerwood 1999, p.63). This means that the skills and confidence of low-income people have to be developed in addition to giving them access to credit provision. Therefore, the microfinance approach is not a minimalist approach offering only financial intermediation but an integrated approach offering both financial intermediation and the other services mentioned above (Ledgerwood 1999, p.65). It can also then be expected to reduce poverty and to develop and strengthen the institutional capacity of local financial systems through finding ways to cost-effectively lend money to poor households (Ledgerwood 1999; Morduch 1999; Otero 1999; Snow 1999; Morduch 2000). This broader function is discussed in more detail in the next section.

As noted earlier, Adams and Fitchett (1992) point out that microfinance institutions are generally characterised by a collage of dynamic, innovative, and flexible arrangements that are tailored to the local economic and social environment. They argue that these arrangements are resilient and that many of them have developed over a long period (Adams and Fitchett 1992, p.3). This flexibility is made possible by the limited regulation, along with smallness of size, with most microfinance institutions operating in a circumscribed area, or in a specific niche of the market where personal knowledge of borrowers is possible (Ghate 1988). The type of transaction is small and short-term transactions, which are based on personal relationships or the institution's intimate knowledge of its clientele (Wai 1992), and which usually occur close to where clients live, shop, or work. To facilitate the clients' entry, microfinance institutions also apply a simple application procedure and loans are disbursed quickly (ADB 2000). The interest rates charged by microfinance institutions are market-oriented and intended to cover both their operational and financial costs, based on the assumption that the poor are willing to pay for access and convenience. To sum up, Wai argues that these arrangements are flexible, adaptable to economic change, innovative, involve low transaction costs for both lender and borrower, and result in high loan recovery rates (Wai 1992, p.340) .

Regarding the transaction costs, a study in India lists four characteristics that explain why microfinance institutions exhibit lower transaction costs than modern banks (Timberg and Aiyar 1984, p.44, 54; Ghate 1992b). First, the microfinance institutions know their clients better than do commercial banks. The lender has had adequate information on the borrower through community and neighbourhood ties or through previous credit transactions. This reduces their information costs compared to those of commercial banks. Second, administrative costs are lower for microfinance institutions than for commercial banks because microfinance institutions' employees are paid less (and are less educated), the establishment is less elaborate, and the paperwork simpler than for commercial banks. Third, the interest rates of microfinance institutions are not regulated and therefore can be adjusted fully to market forces. Non-price competition is

thereby kept down to an optimum level. Fourth, microfinance institutions are not subject to the reserve requirements that are imposed on modern commercial banks.

Finally, the point emphasised here is that microfinance institutions are not only a financial intermediation, but also a development tool supporting rural economic development. The following section discusses the role of microfinance institutions as financial intermediaries based on the experiences of some countries.

2.3 THE ROLE OF MICROFINANCE INSTITUTIONS AS FINANCIAL INTERMEDIARIES

Addressing the function of microfinance institutions as financial intermediaries and their relationships with commercial banks is necessary in order to understand the position and role of microfinance institutions within the whole financial system which, in turn, might have some influences on the sustainability of microfinance institution, that is the main objective of this study.

There have been many studies on this field in developing countries conducted by many researchers. Prabu Ghate - a scholar who intensively studied the relationship between commercial banks sector and microfinance institutions - points out that there has been debate in the literature on whether microfinance institutions and commercial banks are substitutes for each other, or complementary to each other (Ghate 1988; Ghate 1992a; Ghate 1992b). Based on his study in five Asian countries (India, Bangladesh, Thailand, Indonesia, and Philippines) Ghate supports the latter position, arguing that commercial banks and microfinance institutions each have their own areas of comparative advantage (Ghate 1992b, pp. 16-17). He suggests that the commercial banks are more readily able to accommodate large and long-term loans since they rely more on the pooling of deposits and they have greater economies of scale and scope. Hence, the commercial banks are better suited to the needs of large and medium-scale industry, organised trade and commerce, and well-to-do urban households. But they have failed to serve the needs of low-income people in the rural areas in developing countries, such

as micro and small entrepreneurs, small traders, and poor borrowers generally. Ghate argues that the failure is due to the commercial banks being subject to strict regulations relating to capital, reserve and liquidity requirements, ceilings on lending and deposit interest rates, mandatory credit targets, audit and reporting requirement, and overly bureaucratic procedures (Ghate 1992a, p.861).

Ghate (1992b, p.17) identifies at least two comparative advantages of microfinance institutions in serving the low-income people in the rural areas in developing countries, namely the flexibility of their credit procedure, and the provision of small and short duration loans. The flexibility of microfinance institutions regarding collateral enables them to finance a large number of service activities where fixed assets are not created as a security for the loan. Ghate points out that in the case of the borrowers without collateral, the institutions give the loans to them merely based on first-hand information on the borrower, or on the strength of his or her community ties (Ghate 1992a, p. 861). Moreover, inter-linkage of credit with other markets also gives microfinance institutions a comparative advantage in supplying small and short-term loans as working capital loans both in agriculture, such as crop productions loans, as well as in small-scale industry (Ghate 1992b, pp. 153-7).

A more recent study by Remenyi also reveals the reasons why microfinance institutions succeed where modern banks have failed: first, the ability of microfinance institutions to accommodate collateral substitute as an effective basis for client selection; second, their ability to use self-interest to manage risk and maintain near-perfect on-time repayment rates; third, their ability to minimise the cash costs of making small loans and collecting small savings; fourth, their ability to mobilise peer pressure and social mores to enforce contractual obligations; their ability to design and deliver finance ‘products and services’ that meet the needs of the poor; and lastly, their ability to segment the market to keep focused on the poor, yet target the well motivated (Remenyi 2000, p.27).

Based on their areas of comparative advantage, serving different borrower groups and borrowing purposes, Ghate argues that the two sectors are complementary (Ghate 1992b, p. 125). He points out that as the supply of commercial banks serves one purpose (fixed investment), the demand for microcredit increases for a complementary purpose (working capital). He goes on to state that "in the continuum of financial sub-markets arranged in declining order of requirements met by the formal institutions (commercial banks), one end of the continuum consists of sub-markets catered to entirely by the formal institutions (commercial banks), while those at the other end are served entirely by the informal (microfinance) institutions" (Ghate 1992b, p.125). He also argues that "in the middle segment the two institutions usually compete with each other, but sometimes also enjoy a complementary relationship, so that both grow together in absolute size".

A case study of South Korea (Cole and Park 1983, p.50-7) describes the complementary relationship between the two types of institutions in the 1960s and 1970s. Large-scale industry met its fixed investment requirements - such as machinery, equipment, and plant - from the commercial banks, but borrowed part of its working capital requirements from microfinance institutions. Since fixed investment has a longer gestation period than working capital and requires longer term loans, the commercial bank sector is in a better position to provide the loans than microfinance institutions. Cole and Park also point out that microfinance institutions rely more on their own funds than on deposits, hence are less able to provide loans for fixed investment (Cole and Park 1983).

An example in Taiwan shows the case of how microfinance institutions help to compensate for the limitations of the commercial banks system, especially in regard to satisfying the credit needs of small enterprises (Tang 1995). Instead of competing directly with each other, these two sectors have largely complemented each other in solving crucial financial intermediation problems in Taiwan's development process. This complementary function of microfinance institutions is especially important given Taiwan's heavy reliance on small and medium enterprises as a major engine of

economic growth. As is known, the role of small and medium enterprises in Taiwan's export-driven development strategy is very important. In 1985, Biggs (1991 cited in Tang, 1995, p. 848), reveals that small and medium enterprises contributed about 50 percent of value added and employed 62 percent of the workforce in Taiwan.

Furthermore, Tang emphasises that recent changes in Taiwan demonstrate the continued resilience and relevance of micro-credit markets during a process of financial liberation. He estimates that microfinance institutions in Taiwan have provided more than one-third of the total amount of loans to private enterprises in the country. A recent study shows that microfinance institution channels were relied on heavily by small business entrepreneurs in Taiwan (Kan 2000). Using micro data for the period 1977-1992, the emerging period of Taiwan as an industrialised economy, Kan reveals that microfinance institutions as a source of funds are important for small investors' capital accumulation. He concludes that the success of small enterprises in Taiwan was partially attributable to financial intermediation performed by microfinance institutions (Kan 2000, p. 231).

In general, in many other developing countries microfinance institutions also play an important role in serving credit to individuals, farmers, and small-scale enterprises (Adams and Fitchett 1992). The size of microfinance markets in developing countries, in particular informal microfinance markets, is documented in some studies published in the 1990s (Von Pischke, Adams et al. 1983; Germidis, Kessler et al. 1991; Von Pischke 1991; Ghate 1992a; Ghate 1992b; Hoff, Braverman et al. 1993). Each study is based on comparative material drawn from a number of countries. There is common evidence in these writings that microfinance markets remain large, and that most loans in developing countries are provided by microfinance institutions, particularly in rural areas. Conversely, the market share of formal lending (commercial banks) in rural credit markets is relatively small.

Von Pischke, in his book *Finance at the Frontier* (1991, p.173) published by the World Bank, estimates that formal agricultural credit (subsidised credit) probably does not

reach more than 20 percent of farm households in the majority developing countries. Meanwhile, Braverman and Guasch (1993) state that “it has been estimated that only 5 percent of farmers in Africa and about 15 percent in Asia and Latin America have had access to formal credit (commercial banks); on average across developing countries 5 percent of the borrowers have received 80 percent of the credit” (Hoff, Braverman et al. 1993, p. 54).

A study by Siamwalla *et al* (1990) in Thailand reveals that almost 75 percent of those active in the rural credit market used the informal microfinance sector; but in many cases, those household also used the formal sector (commercial banks) in the 1980s. Siamwalla *et al* argue that the persistence of the informal microfinance institutions in Thailand is the result of the rich variety in contractual relations that enable the institutions to solve information problems that are currently beyond the ability of the commercial banks and cooperatives (Siamwalla, Pinthong et al. 1990, p. 272).

An interesting study by Udry (1990) reveals that in rural Nigeria the commercial banks are almost completely absent in the study area and most lending activities are between individuals who lend to each other. Udry argues that the parties are well-known to each other as he found that 97 percent of informal microfinance sector loans by value are between residents of the same village or between relatives (Udry 1990, p. 259). He reports that the respondents of his survey claimed that they know their transaction partners well. Further, he also points out that 65 percent of the remaining informal microfinance sector occurs between individuals who share a long history of exchanging gifts or a long history of previous credit transactions. This study was based on a 1988-89 survey of four villages in northern Nigeria, and found that only 7.5 percent of all loans (by value) come from banks, companies or projects (Udry 1990, p. 255).

A study by Germidis *et al (*1991) published by the Development Centre of the Organisation for Economic Co-operation and Development (OECD) provides findings on the share of formal (commercial banks) and informal microfinance institutions in a large number of developing countries. The data used in this study, which were

collected at different times by different people for different purposes, vary considerably by country. Some sources provide the number of loans, while others cite the value of loans. However, the data are still useful as indications of the generally large informal microfinance markets in developing countries. For example, the study reports that informal microfinance institutions in Bangladesh were estimated to cover 77 percent of farmers' credit needs in 1983, 50 percent in Korea in 1985, 52 percent in Thailand in 1988, and 70 percent in the Philippines in 1970s (Germidis, Kessler et al. 1991, p. 43-45). The study also points out that, during the early 1980s, only 17 percent of agricultural households in Indonesia received credit from the government's special programs. Recent data, based on the estimation of Bank Indonesia and GTZ (2000), suggest that there are 6,123 units of BRI *Unit Desa* and People's Credit Bank (BPR), which are serving almost 28 million low-income clients all over Indonesia. There are also 7,617 units of non-bank financial institutions (such as BKK, LPD, and BKD) serving about 2,084,000 clients and 6,495 cooperatives serving about 6.1 million members. Total clients served by microfinance institutions in Indonesia including NGOs, self-help groups, and *arisan* (Rotating Savings and Credit Associations or simply ROSCAs) are estimated to number about 51 million people, or about a quarter of Indonesia's population. This figure shows that since the early 1980s the number of households receiving credit has increased significantly. A detailed discussion about the development of microfinance institutions in Indonesia is in Chapter 3.

Ghate's work (Ghate 1992a; Ghate 1992b) also documents and summarises other studies which estimate the relative size of microfinance institutions. Ghate comes to the general conclusion that the share of microfinance institutions accounts for about one-third to two-thirds of total rural credit in Bangladesh and China, about two-fifths in India, Sri Lanka and Thailand and two-thirds to three-quarters in Malaysia, Nepal, Pakistan and the Philippines. In India and the Philippines microfinance institutions comprise about two-fifths of total urban credit.

Like other countries, Japan in its early stage of development also relied on microfinance institutions for serving credit to low-income people, particularly in rural areas. Izumida (1992) points out the less well recognized fact that microfinance

institutions - the so-called *kou*[3] - played an important role in Japan (Izumida 1992). Izumida argues that although most *kous* have now disappeared from Japan's current financial system, their influence can still be found in the genes of some of its offspring: the *mujin*-companies and the agricultural cooperatives (Izumida 1992, p.178-9). The discipline involved in saving, repaying loans, and making loans on the basis of creditworthiness traces many of its roots to the *kou* heritage. He also argues that the most important feature of the Japanese experience with the *kou* is how it influenced formal financial institutions that evolved to provide services for the common person. The financial services provided by the credit associations and the *mujin*-companies were logical extensions of the *kou* and built on its strengths, and thus common people saw them as indigenous rather than alien institutions. Japan's experience with *kou* provides interesting lessons for low-income countries that are struggling to modernise their financial systems. In the conclusion of his article, Izumida points out: "Perhaps governments and donors ought to take a more careful look at the existing informal (microfinance) institutions and attempt to build on that system, rather than trying to destroy it" (Izumida 1992, p.179).

Another sense in which the commercial banks and microfinance sectors are complementary is the considerable flows of funds, or "linkages" that already exist between the two sectors (Ghate 1992b). These funds flow in both directions, although in rural credit the predominant flows seem to be from the commercial banks to the microfinance institution. Hence, the banks are often an important source of funds for traders and moneylenders who on-lend informally. A study by Alam (1989), cited by Ghate (1992a, p.862), reveals that one half to two-thirds of rural informal loans

[3] Izumida (1992) describes *Kou* as a simplified name for group savings and loans associations. They were a popular form of financial intermediation, especially in rural areas, until the mid-1900s. Sometimes the more comprehensive terms of *tanomoshi-kou* and *mujin-kou* (or simply *mujin*) have been used with only slight differences in their meanings. *Tanomoshi-kou* connotes mutual help or helping the poor, while *mujin-kou* suggests money making or finance. In rural areas the term *tanomoshi-kou* has been more frequently used, while in urban areas the term *mujin* is more common. Using the data from the Central Bank of Japan, Izumida (1992) states that there were 985 registered *kous* in Kyoto Prefecture having 149,000 individual members in 1910. In Fukushima Prefecture there were about 4,000 *kous* and in Hiroshima 22,376 kous with 3.9 million yen in *kous* funds. In 1934, data from the Ministry of Agriculture of Japan estimated that there were about 350,000 *kous* in the country, involving 5 million people.

originated with the banks and was on-lent by informal lenders (microfinance institutions). In India, a study finds that traditional or indigenous banks (microfinance institutions) actually obtain refinancing from the banks, although this has now been discontinued due to the banks' cutting of funds since 1970 (Timberg and Aiyar 1984).

In the reverse direction, the banks are repositories of funds that flow in from informal lenders (microfinance institutions). Ghate (1992a) states that rotating savings and credit associations (ROSCAS), which are ubiquitous in Asia and mobilise considerable savings, often deposit idle funds in banks. So do credit unions, savings groups, and money lenders. Bouman (1989), as cited by Ghate (1992b, p. 133), argues that this is mainly because they are motivated by the greater security of keeping funds in the banks and use checks to make loans to members.

In the middle segment of the continuum the two institutions sometimes compete with each other in meeting the same borrowing purpose (e.g. crop loans) as against complementing each other in fulfilling the credit needs of complementary purposes (Ghate 1988; Ghate 1992b). In this substitutive relationship, as commercial loans from commercial banks become more easily available, they displace loans from informal (microfinance) institutions. This is what happened in some developing countries –for example in Thailand, Sri Lanka, and the Philippines - where subsidized agricultural credit has expanded in the last three decades, reducing the share of credit of microfinance institutions. In relation to Thailand, Onchan (1992) points out that it has been observed that microfinance institutions have declined in relative important since the 1970s mainly due to a large expansion in subsidised agricultural credit. However, he also reports that in 1980s microfinance institutions still provided around 30 percent of total loan in rural areas, and most relatively small and poor farmers rely mainly on them for their credit needs (Adams and Fitchett 1992, p.104).

From Sri Lanka, Sanderatne (1992) reports that microfinance institutions also experienced a declining trend from 1957 to 1976 p.87 (Sanderatne 1992, p.87). This was also mainly caused by the substantial increase in various agricultural credit

programs. Then in the Philippines, a study by Agabin *et al* (1989, cited by Ghate, 1992a, p. 863) reveals that a substantial contraction of microfinance institutions took place in the 1980s. An earlier expansion had taken place in the 1970s with the Masagana 99 and other programs, but met with large-scale loan repayment problems, after which cheap rediscounting from the central bank was discontinued. This, and the economic crisis of 1983-85, led to the closure of a large number of rural banks which, along with negative real interest rates, drastically reduced the supply of formal credit (commercial banks). Then microfinance institutions made a come-back and by the mid-1980s reclaimed their 1960s share of total rural credit.

Finally, it can be summarised that microfinance institutions have played a significant role as financial intermediaries in developing countries. The institutions have succeeded in financial deepening, the creation of a separate system of sustainable financial intermediation for the poor, as the institutionist approach predicted. Although in a few cases microfinance institutions compete with the commercial bank sector, most cases show that the microfinance institutions are complementary to the commercial banks sector. It can be argued then that this complementarity has had some influences on the sustainability of these institutions over the decades. This finding is expected to make some contribution to answering one of the research questions of this study.

2.4 INSTITUTIONS AND MICROFINANCE PERFORMANCE

As discussed in the previous sections, most microfinance institutions are located in rural areas and characterised by poor clients, who take out small loans, often with no collateral, and a simple and quick loan procedure. The credit mechanism is flexible and tailored to the socio-economic conditions of local people. This mechanism is mainly aimed at reducing credit risk (default) by delinquent clients, which could have negative effects on the financial performance and sustainability of the institutions. This section discusses some theories on the relationship between the risk problem and the rural credit market, and the role of institutions in overcoming the risk problem and the

development of microfinance institutions in developing countries. Following the World Bank (2002, p.6) institutions refer to the rules or procedures that shape how agents (people) interact and the organizations that implement the rules and codes of conduct to achieve desired outcomes.

Imperfect information in credit markets

In an idealised credit market, credit is traded through competitive markets where supply and demand forces interact and the interest rate is determined through supply and demand (Besley 1994, p.29). In the absence of externalities, competitive markets tend to reach a state of equilibrium (i.e., a state where no participant in the market can improve his/her position without making the position of some other participant worse). Besley points out that exchanges (Pareto improvements) will take place in the market until final equilibrium has been reached. When all Pareto improvements have been made, the market is said to have reached a Pareto optimum,[4] where maximum efficiency is achieved. In other words, a Pareto optimum is a situation in which it is impossible to make anyone better-off without making someone worse-off (Varian 1992). In the case of credit markets, this means that, at that ultimate stage, all borrowers would obtain the loan they were looking for at a price corresponding to the supply/demand situation of the moment. To achieve such an optimum, competition must be allowed to drive the market, external interventions are not needed.

However, credit markets diverge from an idealised market because of imperfect information in these markets (Besley 1994). The specificities of credit markets have led economists to amend the competitive market paradigm. Credit markets are said to be structurally imperfect markets. The imperfection stems from the nature of the goods exchanged in the credit markets. Credit is a special good because it requires repayment over a longer time span. However, repayment is not always made by borrowers, making the presence of external sanctions necessary to enforce claims. This is why Besley suggests that a lender's willingness to lend money to a particular borrower may hinge on having enough information about the borrower's reliability and on being sure that the borrower will use the borrowed funds wisely (Besley 1994, p.29). In addition,

[4] Pareto optimum is named after the famous Italian economist Vilfredo Pareto (1848-1923).

suppliers and borrowers in these markets do not share the same information, which creates imbalances between the two types of actors.

Besley (1994) also argues that even though credit markets are imperfect, they may still achieve a lower standard of efficiency and are referred to as Pareto constrained efficiency. In practical terms, this lower standard explains why the credit supply never meets all of the demand for credit. In other words, the presence of such imperfect information may explain why lenders choose not to serve some individuals. The key concepts of the imperfect information paradigm discussed here are asymmetric information, moral hazard, adverse selection, and credit rationing.

Asymmetric information refers to situations in which one party to a transaction has more information about the transaction than the other. This situation could cause markets to deviate from the conventional behaviour patterns and lead to moral hazards and adverse selections (Arrow 1968; Akerlof 1970; Hillier and Ibrahimo 1993). Following Arrow (1963, 1968), Hillier and Ibrahimo (1993) point out that the problem of moral hazard occurs when one party, known as the principal, enters into a contract with another, known as the agent, who has some degree of autonomy over his consequent actions which cannot be perfectly monitored by the principal. These actions affect the outcome for both the principal and the agent and their preferences differ so that there is some degree of conflict between the two parties. The principal, therefore, wishes to devise a contract which will include the agent undertaking actions, which the principal cannot fully monitor, desired by the principal. The application of this idea to the credit market is as follows. Consider the bank to be the principal and the borrower to be the agent. If the interest rate to be charged on the loan affects the consequent behaviour of the borrower, then the bank may choose to set an interest rate which does not clear the credit market if it chooses the interest rate partly to influence the unobservable behaviour of the borrower and the use made of the loan. For instance, if a higher interest rate encouraged borrowers taking out loans for investment finance to invest in riskier projects, it may be shown that banks may have an incentive to charge a less than market clearing rate in order to induce investment in less risky projects.

The idea of the adverse selection problem was developed by George Akerlof (1970) in his well-known article, "The Market for Lemons: Quality Uncertainty and the Market Mechanism", which analyses a market for used cars. The adverse selection problem occurs in markets where products of different quality are sold to buyers who, because of asymmetric information, cannot observe the quality of the products they purchase. In the used car example, the sellers are knowledgeable about the quality of each car offered for sale; the buyers are not. When buyers cannot distinguish, within a given type of used car, between good cars (high quality products) and those bad cars (low quality products) which in America are known as "lemons", the sellers –who know the quality of each car- can offer the lemons at the same price as the high-quality cars. Akerlof (1970, p. 497-9) also points out that the adverse selection problem also exists in the credit market in developing countries such as India. He points out that while the large banks in the central cities have interest rates of 6, 8, and 10 percent, the local money-lenders charge 15, 25, and even 50 percent. The answer to this seeming paradox is that credit is granted only where the granter has (1) easy means of enforcing his contract or (2) personal knowledge of the character of the borrower. The middleman who tries to arbitrate between the rates of the moneylender and the central bank is apt to attract all the "lemons" and thereby make a loss.

As noted above, both adverse selection and moral hazard exist in credit markets. These forms of asymmetric information will lead to credit rationing. The following section surveys developments in the theory of credit markets focusing on credit rationing and their usefulness for policy analysis. The purpose here is to examine some of the main ideas in imperfect information credit models in the context of microfinance institutions and their experiences in developing countries.

Jaffee and Russel (1976) develop a specific model of how imperfect information and uncertainty can lead to rationing in the loans markets. They analyse the behaviour of a loan market in which borrowers have more information about the likelihood of default than do lenders (Jaffee and Russel 1976). Their model is a model of credit rationing

with two types of borrowers: ‘honest’ and ‘dishonest’. The honest borrowers accept only loan contracts that they expect to repay and, under their assumptions, they do in fact repay them. The honest borrowers repay their loans even when there is a financial incentive to default. The dishonest borrowers, in contrast, default on loans whenever the costs of default are sufficiently low or financially advantageous. Since lenders cannot distinguish among borrowers, it might be best to ration credit in order that dishonest borrowers will not default, even though doing so reduces the profitability of lending to honest borrowers. Therefore, the optimal credit-rationing policy depends on the proportion of honest borrowers because of the adverse selection problem.

In their paper, Stiglitz and Weiss (1981) develop a model of a competitive banking system under the condition of asymmetric information. The banks (the lenders) are similar to Akerlof’s uninformed used car buyer and the lenders, like the car dealers, are the informed party. Similar to the quality of used cars being unknown to the buyers, the quality (risk profile) of the borrowers – their investment choice, honesty, risk tolerance, capacity and willingness to repay the loans, and so on- is unknown to the banks. As a result, the banks (lenders) may charge higher interest rates to offset risk caused by asymmetric information (the borrower knows more about their use of the loan and their repayment intentions than the bank does). While the higher interest rates increase the returns to successful loans, the average riskiness of loan applicants may increase because low-risk borrowers may choose not to borrow at the higher interest rates (the adverse selection effect of interest rates).

Stiglitz and Weiss (1981) also point out a moral hazard problem. Increases in the interest rate, while raising the return to successful loans, may lead to adverse shifts in the risk composition of lenders’ portfolios, increasing the probability of default. It follows that increases in the interest rate may lead to a decrease in the expected profit to lenders. Then the moral hazard and adverse selection effects may render a market-clearing interest rate non-optimal, leading to credit rationing. In brief, in this form of credit rationing the bank denies credit to prospective borrowers not because of lack of

funds but because of perceived risk related to asymmetric information (Stiglitz and Weiss 1981).

However, Bester (1985) has a different point of view regarding credit rationing. He argues that credit rationing might not be necessarily in equilibrium if banks can compete by offering contracts with different collateral requirements and interest rates (Bester 1985), an option not considered by Stiglitz and Weiss (1981). Perfect self-selection is obtained when high-risk borrowers choose contracts with higher interest rates and lower collateral. This result assumes that borrowers (in particular, those with low-risk) are not constrained by the amount of collateral they can provide. In 1986 Stiglitz and Weiss respond that the possibility of credit rationing remains under some conditions in real credit markets, including adverse selection and moral hazard (Stiglitz and Weiss 1986).

Braverman and Guasch criticise Bester's view on the unnecessariness of credit rationing. They argue specifically that credit rationing would remain in real rural credit markets and there is a real constraint in the markets. The collected evidence indicates that securing loans through collateral is not often feasible in rural areas (Braverman and Guasch 1986; Braverman and Guasch 1989). In fact, a fair proportion of loans are supplied without any collateral to small farmers who lack title to their property and are producing under tenancy arrangements. That clearly hampers the self-selection equilibrium, throwing it back to credit-rationing as described by Stiglitz and Weiss (1981). Braverman and Guasch also point out that the adverse selection and moral hazard problems seem much less severe for the microfinance institutions (informal or village money lenders) than for the commercial banks (organised commercial lending institutions), as indicated by the fact that the default rate for the latter is much higher than for the former (Braverman and Guasch 1986, p.1260; Braverman and Guasch 1989, p.18). They argue that this condition is caused by the fact that information available to the microfinance institution is more extensive, more accurate, and easier to obtain than for the commercial banks. Herath (1996) also reveals that the problem of asymmetric information (adverse selection and moral hazard) appear to be less serious

in rural credit markets. The highly localised nature of these markets and greater availability of information has a risk-reducing effect (Herath 1996, p.250).

An article by Hoff and Stiglitz (1990) discusses specifically the relationship between imperfect information and rural credit markets. They point out that rural credit markets are based on the following three observations (Hoff and Stiglitz 1990, p.237):

1. Borrowers differ in the likelihood that they will default, and it is costly to determine the extent of that risk for each borrower. This is known as the *screening* problem;
2. It is costly to ensure that borrowers take those actions which make repayment most likely. This is the *incentives* problem; and
3. It is difficult to compel repayment. This is the *enforcement* problem.

To solve the three problems, Hoff and Stiglitz (1990, p.238) suggest two types of mechanisms. First, indirect mechanisms rely on the design of contracts by lenders such that, when a borrower responds to these contracts in his own best interests, the lenders obtain information about the riskiness of the borrower and induce him to take actions to reduce the likelihood of default and to repay the loan whenever he has the resources to do so. Second, direct mechanisms rely on lenders expending resources to screen applicants and enforce loans. It follows from this that high interest rates may reflect the high costs of these activities. Perhaps more important, however, these direct mechanisms (through personal relationships, trade-credit linkages, usufruct loans, and so on) lead to a monopolistically competitive structure with interest rates spread between different segments of rural credit markets. Moreover, this suggests that the money lenders' power is unlikely to be broken by the entry of institutional credit, unless the new institutions themselves find substitutes for the direct mechanisms used by moneylenders to overcome the problems of screening, incentives, and enforcement.

Besley (1994) points out three features of rural credit markets. The first feature is scarcity of collateral. Besley states that one solution to the repayment problem, as a result from moral hazard and adverse selection problems, is to have the borrower put up a physical asset that the lender can seize if the borrower defaults. However, in rural credit markets generally the borrowers are too poor to have assets that could be used as collateral. The second feature is the underdevelopment of complementary institutions.

In rural areas of developing countries, poorly developed communication may also make the use of formal (commercial) bank arrangements costly for many individuals. In addition, complementary markets may be missing such as insurance markets that could mitigate the problems of income uncertainty. If individuals could ensure their incomes, default might be less of a problem. Another way to mitigate the default problem is to assemble individual credit histories and to sanction delinquent borrowers. Such means are commonplace in developed countries. However, they require reliable systems of communication among lenders that seldom exist in rural areas of developing countries. Therefore, policy interventions are needed, for example, through programs that raise literacy levels that could improve the operation of credit markets (Besley 1994).

The third feature is covariant risk and segmented markets. A special feature of agriculture is the risk of income shocks because of weather fluctuations as well as changes in commodity prices. Such shocks affect the operation of credit markets if they create the potential for a group of farmers to default at the same time. This risk could be averted if lenders held loan portfolios that were well diversified. However, credit markets in rural areas tend to be segmented. A lender's portfolio of loans will concentrate on a group of individuals facing common shocks to their income, in one particular geographic area, for example, or on farmers producing one particular crop, or on one particular kinship group.

In summary, the most important factors affecting the allocation of credit, particularly in rural credit markets, are: (1) lack of collateral on the part of the borrower due to finiteness of borrowers' wealth, (2) adverse selection problems, (3) moral hazard problems, and (4) problems of insufficient number of instruments for screening and enforcement. The following section discusses how developing countries deal with these problems.

The role of institutions on the performance and sustainability of microfinance institutions

Douglas C. North defines institutions as the rules of the game in a society, or, more formally, the humanly devised constraints that structure human interaction (North 1990, p.3; North 1991, p. 97; North 1994, p.360; North 1995, p.23). In a more practical way, institutions can be defined as the rules or procedures that shape how agents (people) interact and the organizations that implement the rules and codes of conduct to achieve desired outcomes (Brinkerhoff and Goldsmith 1992, p.371; World Bank 2002, p.6). Institutions include laws, formal (government) regulations, cultures, conventions, social norms, and self-imposed codes of conduct. Thus, institutions are important because they provide a structure for everyday life by defining and limiting the set of choices of individuals and organizations. Accordingly, the institutional environment is defined as the set of fundamental political, social, and legal ground rules that establishes the basis for production, exchange, and distribution (Davis and North 1971, p.6).

Institutions are classified in two types which are formal and informal institutions (North 1991, p.97; North 1994, p. 360; North 1995, p.23; World Bank 2002, p.6). Formal institutions include the rules written into the law and regulations by government, rules codified and adopted by private institutions, and public and private organizations operating under public law. Informal institutions, which often are operating outside the formal legal system, reflect unwritten codes of social conduct such as social norms and sanctions and using social mechanisms to assess creditworthiness based on the reputation of the agents involved. It is argued that in situations where formal institutions (regulations) fail, informal institutions will come into play to reduce uncertainty and provide constancy to individuals and organizations (Braverman and Guasch 1986; Braverman and Guasch 1989; North 1990; Besley 1995; World Bank 2002). Conversely, when informal institutions fail, formal institutions will play their role (World Bank 2002). Another possibility is integrating informal and formal institutions. The World Bank (2002) argues that building bridges between informal institutions and formal institutions is an effective means of enhancing the

success of formal institutions. However, as argued by the World Bank (2002, p.172), building formal institutions that complement existing informal institutions means adequate attention must be paid to norms and culture in order to deliver desired outcomes.

Institutions influence individuals' decision making by signalling which choices are acceptable and determining which norms and behaviours are socialised in a given society (Powell and DiMaggio 1991). Institutions also affect the actions of organizations by constraining which actions are acceptable and supportable within the environment (Aldrich and Fiol 1994). There are many studies in the literature that discuss the influence of institutions - both formal and informal - on the performance and sustainability of economic/business entities or firms. The evidence strongly suggests that the success and sustainability of firms, including microfinance institutions, has been very much influenced by their institutional – both formal and informal institutions - environments (Meyer and Rowan 1977; DiMaggio and Powell 1983; Baum and Oliver 1991; Rhyne and Otero 1992; Carrol 1993; Chaves and Gonzales-Vega 1996; Oliver 1997; Snow 1999).

In one of his articles on the credit market, Besley (1995) argues that the developing countries have developed non-market institutions (informal institutions) for coping with risk and providing credit. Besley uses the term "non-market institution" as a catch all for many different arrangements of practical microfinance such as in credit cooperatives, informal credit and insurance arrangements, and rotating savings and credit associations. In most cases, those institutions make relatively little use of the formal contractual obligations enforced through a codified legal system. There can, however, be well-defined rules of operation among the members of institution, which are either embodied in a constitution or time-honoured tradition such as social norms, historical patterns, and management procedures (Braverman and Guasch 1986). Such arrangements tend to be non-anonymous, with parties to any transaction knowing each other well.

The informal institutions tend to exploit a comparative advantage in monitoring and enforcement capacity (Arnott and Stiglitz 1990; Stiglitz 1990). They argue that the comparative advantage of informal non-market institutions in terms of monitoring is that individuals who interact in a variety of non-market contexts tend to know each other well. Thus they have a greater ability to monitor each other than do formal financial institutions, such as banks. This can explain why many non-market institutions function effectively where formal institutions fail.

A more recent article (Fuentes 1996) proposes microfinance institutions utilise a member of the rural (local) community to act as an agent in screening potential borrowers and collecting repayment. Fuentes argues that incorporating village-level information on borrower risk characteristics, helps to mitigate the information problems that hamper the performance of financial institutions when lending to low-income people, both in rural and urban areas (Fuentes 1996, p.189). In addition, by gaining access through the agent to village-level enforcement mechanisms (such as social sanctions), the financial institution may also mitigate some of the problems it faces when collecting repayments.

There have been wide variations in the use of village agents who have been utilised in the microfinance delivery system. Onchan (1992) states that in Thailand, the Bank for Agriculture and Agricultural Cooperatives (BAAC) has attempted to reduce transaction costs by considering using farmers' leaders, that is, village headmen, to act as its 'agents' in the village (Onchan 1992, p.114-5). The Ministry of Finance directs BAAC to provide relatively large amounts of loans to groups of low-income farmers. The credit is given to the groups with no collateral. In order to reduce transaction costs, BAAC uses farmer leaders, that is, village headmen, to act as its agents in the villages. These agents help BAAC in loan processing by using their knowledge of borrowers and they are paid for their services by the bank. BAAC attempts to access the information about potential borrowers in the village through this innovation. As its loan agent, BAAC expects the village leader to help improve the loan processing procedure and the repayment rate. Even though the agents cannot be informal lenders, they

usually are respected by farmers. Therefore, their personal contacts may improve the operational efficiency, particularly in regard to the transaction costs of the bank.

Bangladesh experiences with Bangladesh Rural Advancement Committee's (BRAC), Grameen Bank, and Proshika, have shown how loan facilitators or 'brokers' have been used to connect the institutions and the low-income clients (McGregor 1988, p. 475-6). Specifically, McGregor states that the bank-broker relationship has probably been the most common in Bangladesh. Donor funded and non-governmental development projects act as brokers in the relationship between the target population and the banks. There is little or no direct contact between the target group and the banking system. Potential borrowers are identified by project (broker) staff, and greater parts of the process of arranging credit are taken out of the hands of both the bank and the target population. Activities under taken by the project (broker) may include: the decision as to who will be eligible for loans, the writing out of loan applications, the submission of applications to the bank, and the collection of repayments.

Many Indonesian microfinance institutions, such as Sub-district Credit Institution (Badan Kredit Kecamatan or BKK) of Central Java and Village Credit Institution (LPD) of Bali, have already incorporated village agents into their credit delivery systems (Yaron 1992; Chaves and Gonzales-Vega 1996). Chaves and Gonzales-Vega (1996) call this technique character-based lending. They argue that character-based lending is a very advantageous and cheap technique because local information about the borrower is a sunk cost, in the sense that it is an asset that does not have a value outside the local financial market and is acquired in a slow fashion, the only required expense resulting from having been in the location for a sufficiently long period of time. Local agents can also acquire additional information at lower costs than outsiders (Chaves and Gonzales-Vega 1996, p.70-1). Moreover, Chaves and Gonzales-Vega also point out that character-based lending and local monitoring have been comparatively efficient in avoiding costly mistakes in assessing the probability of loan repayment. These points are further discussed in Chapters 3 and 6 that focus on the credit delivery mechanisms of the LPD of Bali.

The comparative advantage of informal institutions in terms of enforcement has two features (Besley 1995, p.118). First is the scope of sanctions. In most social structures, mechanisms of social control already exist to limit antisocial behaviour. Hence, an individual who fails to honour an obligation can be punished, even if no written contract has been violated. Second is the depth of sanctions. In developing countries, many formal institutions, such as banks and insurance companies, are new, but there is a long history of cooperation in informal settings. This may reflect relative immobility that comes from regional and kinship ties. In regard to the sanctions, cultural norms and practices (non-market institution) can act as an enforcement mechanism, replacing external supervision with internal self-supervision and external legal sanctions such as fines with internal emotional sanctions such as guilt and shame (Casson 1993, p.418).

As stated in the research questions in Chapter 1, this study reveals not only the influences of informal institutions but also the influences of formal institutions on the practical arrangement of microfinance institutions (LPD of Bali). Moreover, this study also reveals the influences of the informal institutions on the formal institutions in regard to their influences on the practical operational arrangement of the LPDs and, in turn, their influences on the performance and sustainability of the LPDs.

2.5 PERFORMANCE MEASUREMENT OF MICROFINANCE INSTITUTION

As discussed in Chapter 1 and the previous section, one of the objectives of this study is to evaluate the financial performance and outreach indicators of the LPDs and to assess the influences of informal and formal institution on those indicators. This section presents the performance measurement of microfinance institutions. The discussion includes the way to address the performance, several performance assessment approaches, and the performance indicators being used in this study.

Performance assessment of microfinance institutions has to be based on the objectives of the institutions. Although the main objective of most microfinance institutions is to improve the welfare of the poor, there have been two approaches to achieve the objective as discussed in the previous section. While the welfare approach measures success mainly by how well it fulfils the needs of the poorest in the short term, or poverty reduction, the institutional approach measures success by the sustainability of the institutions assuming that self-sustainable microfinance institutions are likely to contribute to income expansion and poverty reduction.

As noted earlier, since microfinance institutions are seen as financial intermediaries aiming to give better access to credit for low-income people, the institution is expected to be financially viable in achieving its self-sustainability. Consequently, the performance measurement in part has to be based on its financial viability.[5] Cost efficiency should be the primary concern in order to achieve the self-sustainability of the institution (Khandker 1998). However, in the literature performance measurement is based not only on self-sustainability but also on the outreach of the institutions, measured by the coverage of target households and the extent of services they receive. Outreach indicators are considered as proxies for impacts of microfinance institutions on development (Yaron, Benjamin et al. 1997). The twin criteria of self-sustainability and outreach – which are complementary - have been the yardstick of microfinance performance evaluation (Yaron 1992; Yaron 1994; Christen, Rhyne et al. 1995; Chaves and Gonzales-Vega 1996 ; Yaron, Benjamin et al. 1998; Ledgerwood 1999).

The assessment framework of Yaron can be seen in Figure 2.1 (Yaron, Benjamin et al. 1997, p.90). The first criterion is self-sustainability, which can be achieved when the return on equity, net of any subsidy received, equals or exceeds the opportunity cost of the equity funds. Subsidy dependence is the inverse of self-sustainability (Yaron 1992). Traditionally, microfinance institutions have been sustained by various types of implicit or explicit subsidies to continued operations.

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[5] Financial viability refers to the ability of a microfinance institution to cover its costs with earned revenue.

The most common subsidies have been differences between the market interest rate and interest rates paid on concessional borrowing from the state or donor, state assumption of foreign exchange losses on loans denominated in foreign currencies, obligatory deposits by other financial or public institutions at below-market rate, direct reimbursement by the state or donor of some or all operating costs, and exemption from reserve requirements or forced investment (Yaron 1994). In the self-sustainability approach – which is the main objective of the institutional approach discussed in Chapter 1 – donations (subsidies) cover start-up costs and fund experiments meant to fund innovations that reduce the cost of supply, so that revenue from clients can cover costs in the long run (Schreiner 2002). This is the case of the Village Credit Institutions (LPD) of Bali which only receive a starting capital of Rp10 million from the Provincial Government of Bali for each institution according to provincial regulation (Government of Bali 2002).[6] As the LPD does not receive subsidy in the form of an interest rates subsidy, it is not necessary to calculate the subsidy dependence index (SDI). As stated by Yaron (1994, p.57), the SDI measures the percentage increase in the average on-lending interest rate required to compensate for eliminating subsidies, including the subsidy a microfinance institution receives through paying interest below the market rate on its borrowed funds (mostly rediscounting facilities with the central bank or soft loans from donors). However, other indicators of self-sustainability such as operational self-sufficiency and financial self-sufficiency are calculated in this study.

The second criterion is the number of clients served and the variety of financial services provided. This is an outreach objective, which consists of scale and depth of outreach.[7] Scale of outreach refers to the number of clients served with different types

[6] The LPDs in Bali rely on savings and deposits rather than on credit and grants as their source of refinancing (BI & GTZ, 2000).

[7] Outreach is measured by a hybrid index comprising several indicators, such as the number of clients, the amount of savings and the average value of savings accounts, the average of loans size (as a proxy for income level of the clientele, the number of branches and village post/units, the variety of financial services offered, the percentage of the target population served, the annual growth of microfinance institutions assets over recent years in real terms, and women's participation (where social norms discriminate against women).

of instrument and the depth of outreach refers to the type of clients reached and their level of poverty.

Based on these two important criteria – the self-sustainability and the outreach – several performance assessing techniques have been developed in 1990s (CGAP 2001). The key features of some important approaches are presented in Table 2.1. First, ACCION[8] Approach which adopts the original CAMEL methodology to evaluate U.S. commercial lending institutions (CGAP 2001). CAMEL is the acronym of Capital adequacy, Asset quality, Management, Earnings, and Liquidity. While the ACCION CAMEL issues a composite score, similar to a rating, it is not meant to measure credit risk. The final score ranges from 0 to 5, or D to AAA. A microfinance institution scoring below 2 should be operating a lending business. Scores from 2 to 3 indicate microfinance institution with fundamental weaknesses that must be corrected. The purpose of this tool is to strengthen management and generate a common framework for evaluating and comparing the performance ACCION affiliates across countries such as in Latin American countries.

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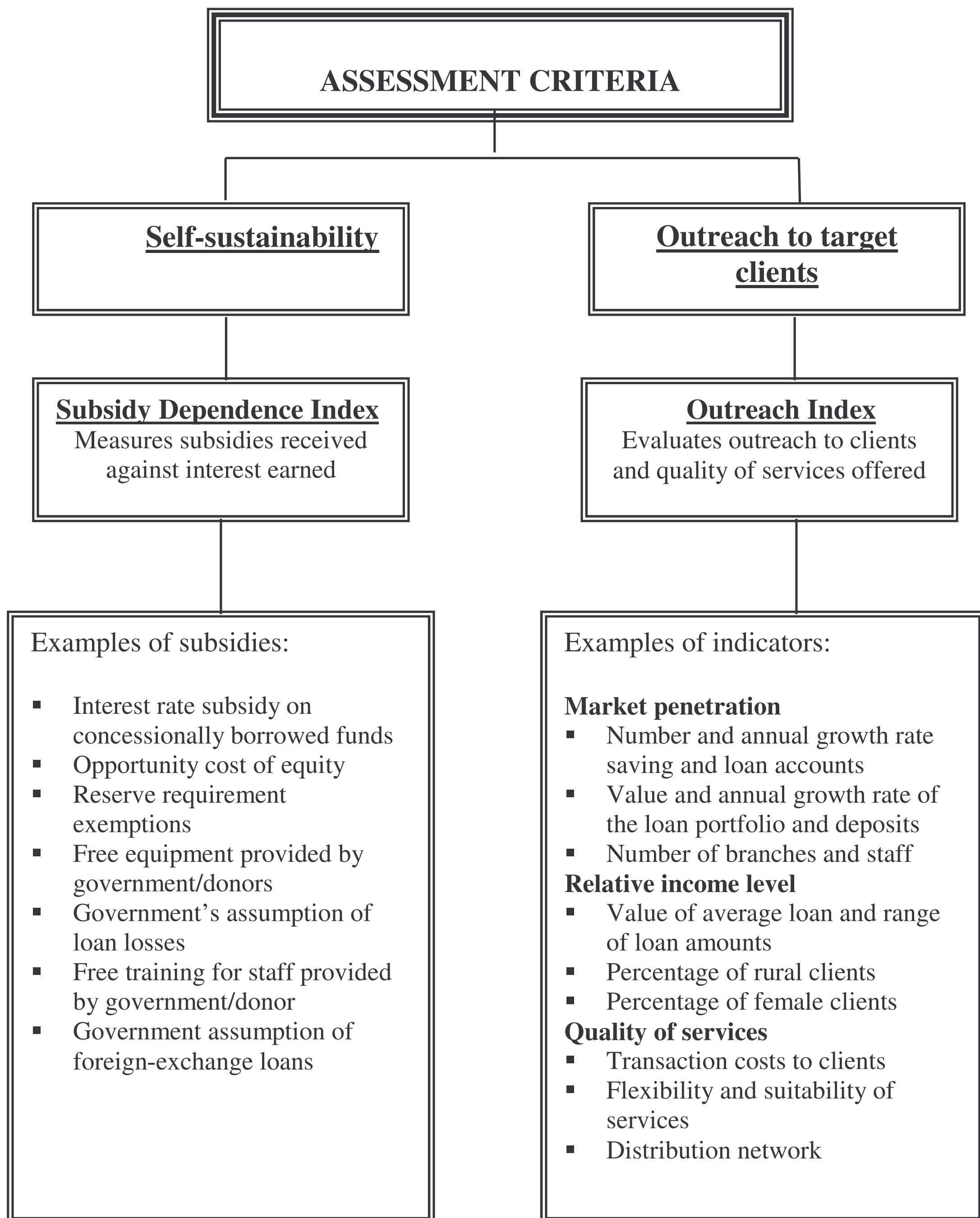
[8] ACCION International is an organisation aims to reduce poverty in North and South America by providing small loans. It was founded in 1961 and based in Boston, Massachusetts.

Figure 2.1 Assessing the Performance of Microfinance Institutions



Source: Yaron, *et al* (1997)

Table 2.1 Microfinance Assessment Performance Approaches

	ACCION CAMEL	WOCCU PEARLS	PLANET RATING GIRAFE	MICRORATE
Purpose of evaluation	Internal tool for management, board, and network	Ongoing performance monitoring by management, and external supervisors	Measurement and control of risk	1. Evaluate micro-finance institution credit risk for potential investors and creditors 2. Influence micro-finance institutions performance 3. Compare micro-finance performance
Main clients	ACCION affiliates. More recently, bank supervisors and second-tier institutions	Affiliated credit unions, leagues, and credit union regulators	Donors (AFD, BNDES), investors (Blue Orchard, Financial Bank), creditors, NGOs (CARE, VITA) and microfinance institutions	Donors (50%), microfinance institutions (30%), and investors (20%)
Key feature of methodology	Roadmap to microfinance seeking to become formal financial intermediaries	Pinpoints key financial strengths and weaknesses	Detailed rating opinion but unclear definition of risk level	Creditworthiness (Recommend/Watch/Caution) and rationale; benchmarking and peer group comparison
Approach bias	Strong on management, profitability, and benchmarking practices	Strictly financial. Includes comprehensive financial analysis	Strong on management, governance, and best practices	Strong on financial track record and benchmarking against peers
Qualitative vs. quantitative	More qualitative (53%) than quantitative (47%). Original CAMEL was 70% quantitative	All quantitative	More qualitative (57%) than quantitative (43%). More weight to fiduciary risk	More quantitative than qualitative
Limitations		No qualitative evaluation	Reliance on external consultants	Relatively little judgemental input

Source: CGAP (2001)

Second, the World Council of Credit Unions (WOCCU) - a non-profit organization that promotes the development of financial cooperatives, headquartered in Madison, Wisconsin - uses PEARLS in assessing the performance of microfinance institutions (CGAP 2001). PEARLS is a set of 45 ratios used to evaluate and monitor the financial stability of credit unions within WOCCU, especially for use in its institutional strengthening programs. PEARLS are grouped under six areas of financial

performance: protection, effective financial structure, asset quality, rates of return and costs, liquidity, and signs of growth (PEARLS). The PEARLS methodology is driven by financial performance. However, PEARLS does not explicitly address management, though an institution's financial performance obviously says a great deal about its management.

Third, PlaNet Rating – a branch of PlaNet Finance, an international non-profit organisation based in Paris - uses GIRAFE rating in assessing the performance of microfinance institutions (CGAP 2001). GIRAFE's 26 indicators are grouped under six areas of risk: governance and decision making process, information and management tools, risk analysis and control, assets including loan portfolio, funding (equity and liabilities), and efficiency and profitability. Among other approaches, GIRAFE gives the most weight to 'fiduciary' risk how an institution is governed, and whether it may fail to meet investors' and shareholders' expectations because of inadequacies in systems, processes, and organisation. The methodology focuses more on management than on risk. Fourth, is the approach proposed by MicroRate (CGAP 2001), a limited liability company based in Washington D.C. MicroRate's methodology focuses on how the various risks of a microfinance institution operations affect the institution's credit worthiness. The main components of this methodology are (1) identifying key risk areas and their drivers; (2) comparing the microfinance institution's performance with that of its peers on an adjusted basis; and (3) making this information available to the market where possible. The key factors driving the evaluation are efficiency, asset quality, growth, and profitability. MicroRate has completed about 70 assessments so far, most of them in Latin America.

All of the four techniques presented above are applicable to assess the performance of microfinance institutions. However, in selecting an assessment technique, some contextual factors must be considered, such as the geographical context (appropriate benchmarks in Latin America are not necessarily adequate for Asia and Africa), the maturity of the institutions (younger institutions may be incurring expansion costs without commensurate revenue and should not be compared to mature institutions), and

the varying lending approaches that are used (Ledgerwood 1999). Performance indicators must be put in the context of where and how the different microfinance institutions are operating. Moreover, Ledgerwood argues that the majority of the present assessment techniques are based on the assumption that most microfinance institutions are primarily lending institutions. Hence, she proposes an assessment technique in her book *Microfinance Handbook* published by the World Bank (1999) as presented in Table 2.2.

Ledgerwood points out that this technique has been drawn from a number of microfinance institutions, both formal and semi formal, around the world. She points out that each of these performance indicators was chosen because they are useful in managing microfinance institutions (internal management) such as productivity and efficiency. Many of them (including financial viability, profitability, leverage and capital adequacy ratios, and scale, outreach, and growth) are also useful for external parties, such as investors or donors (Ledgerwood 1999, p.205).

Considering the nature of the LPDs of Bali which were designed as financial intermediaries from the beginning, and the ability of the LPDs to rely on savings and deposits rather than on credit and grants as their source of refinancing (Bank Indonesia and GTZ 2000), the availability of data, appropriateness in geographical context, and the end users of the assessment, Ledgerwood's approach seems to be the most appropriate one to be used in this study. The calculation technique for the indicators chosen in this study is provided in Appendix 1.

Table 2.2 The Performance Indicators of Microfinance Institutions (Ledgerwood's Approach)

Areas	Indicators
Portfolio quality	▪ Repayment rates ▪ Portfolio quality ratios (arrears rate, portfolio at risk, ratio of delinquent borrowers) ▪ Loan loss ratios
Productivity and efficiency	▪ Productivity ratios (number of active loans per credit officer, average portfolio outstanding per credit officer, amount disbursed per period per credit officer) ▪ Efficiency ratios (operating cost ratio, cost per unit of currency lent, cost per loan made)
Financial viability	▪ Financial spread ▪ Operational self-sufficiency ▪ Financial self-sufficiency ▪ Subsidy Dependence Index
Profitability	▪ Return on Assets Ratio ▪ Return on Business Ratio ▪ Return on Equity Ratio
Leverage and capital adequacy	▪ Leverage (debt to equity ratio) ▪ Capital adequacy standards
Scale, outreach, and growth	▪ Clients and staff (number of clients, number of staff, number of branches, percentage of total target clientele serviced, etc.) ▪ Loan outreach (number of currently active borrowers, total balance outstanding loans, average outstanding portfolio, average disbursed loans size, average disbursed loans size as a percentage of GDP per capita, value of loans per staff member, number of loans per staff member, average outstanding loan size, average outstanding loan size as a percentage of GDP per capita, etc.) ▪ Savings outreach (total balance of voluntary savings accounts, total annual average savings as a percentage of annual average outstanding loan portfolio, number of current voluntary savings clients, value of average savings account, number of savers per staff member, average savings deposits as a percentage of GDP per capita, etc.)

Source: Ledgerwood (1999) tabulated by author.

2.6 SUMMARY

From a review of the literature, it is evident that the role of microfinance institutions as financial intermediaries in developing countries is very important. Many studies have shown that microfinance institutions have succeeded in achieving its role as healthy financial institutions that serve poor people. It can be argued that its complementarity with the commercial banks can be regarded as one of the factors affecting their sustainability over the decades.

Microfinance institutions in developing countries have employed unique and diverse practical arrangements that are based on informal institutions in order to cope with the risk in providing credit in the rural credit market. The microfinance institutions arrangements are rooted in these existing informal institutions. In developing countries, microfinance institutions make relatively little use of formal contractual obligations enforced through a codified legal system. However, there are well-defined rules of operation among the members of the institution, which are either embodied in a constitution or are time-honoured traditions such as social norms, historical patterns, and management procedures. The argument here, to be developed in Chapter 6, is that non-market institutions (informal institutions) have a significant influence on the performance of the Village Credit Institutions (LPD) of Bali.

In sum, a good performance and sustainability of microfinance institutions depend upon both internal and external factors. Many studies reveal that the internal factors - such as its management and credit mechanisms – have played an important role in the success of microfinance institutions in achieving their goals. The external factors – such as socio-economic conditions, regulations environment, and high degree of risk caused by imperfect information in rural credit markets – have also influenced their performance and sustainability.

CHAPTER THREE

MICROFINANCE INSTITUTIONS IN INDONESIA: THEIR DEVELOPMENT, LANDSCAPE, AND REGULATION

3.1 INTRODUCTION

It has been argued that Indonesia is home to the world's largest financial self-sufficient microbanking system and many smaller commercial microfinance institutions, which in terms of scale, variety, and volume, market penetration, and profitability, are the most developed in the world (Berenbach 1997; Robinson 2002). This chapter charts the development of the institutions in Indonesia. The first part of the chapter presents the development of microfinance institutions in Indonesia since the colonial period (the Dutch period) until the present time. This section reveals the reasons for the establishment and development of microfinance institutions in Indonesia and the role of the central and provincial governments in these two activities. The second part illustrates the landscape of microfinance, presenting information about the configuration of microfinance institutions in Indonesia, including the types, number, and approaches of the institutions to economic development as described in the previous chapter. Knowledge about the landscape provides information on the microfinance market as a whole and its competitive condition. The last part of this chapter describes the legislation/laws related to the development of microfinance institutions in Indonesia and the organisations involved in and responsible for supervision and guidance of the institutions. An understanding of the development context, the microfinance landscape, and the legislation of the institutions will provide useful insights in assessing the performance of the Village Credit Institutions of Bali

(*Lembaga Perkreditan Desa* or LPD) and the affecting factors, which is the objective of this study. The LPD of Bali – the case study in this thesis - is among the types of microfinance institutions in Indonesia that are considered to operate successfully in Indonesia (Christen, Rhyne et al. 1995; Chaves and Gonzales-Vega 1996). The socio-economic environment of Bali which significantly contributes to the understanding of how the LPD deals with the problem of imperfect information outlined in Chapter 2 is discussed in the next chapter.

3.2 THE DEVELOPMENT OF MICROFINANCE INSTITUTIONS IN INDONESIA

The Colonial Period

The development of microfinance in Indonesia started more than a hundred years ago. It began with the establishment of *Hulp en Spaar Bank Der Inlandsche Bestuurs Amtenaren* (also called the *Priyayi Bank of Purwokerto*) by Raden Aria Wirjaatmadja[9] in December 1895 which was established to meet the local government employees' needs in Purwokerto, Central Java (Suharto 1988, p.28-9; Danusaputro, Suharto et al. 1991, p.16). The initial capital of the bank was collected from indigenous and European people in Purwokerto by the Dutch administrator E. Sieburgh. The main purpose of the establishment was to free the local administrative officials (indigenous Indonesian) from the grip of usurers (mainly Chinese and Arab moneylenders) and to preserve "the spirit of brotherhood and solidarity" among the rural population (Schmit 1994, p.1). The bank provided loans to its clients (members) and mobilised funds through savings and subscription from its members.

In 1897 the Dutch administrator Sieburgh was replaced by De Wolff van Westerrode, who was a keen supporter of agricultural credit. He redeveloped and reorganised the bank in order to cover and help more clients, especially from agricultural sectors, under its new name, *Poerwokertosche Hulp, Spaar en Landbouwcredietbank* (Suharto 1988, p.33). The new bank was inspired by, and based on, the principles of the German

[9] Raden Aria Wiriatmaja was a Javanese government official from an aristocratic (*priyayi*) family.

pioneer Raiffeisen credit cooperatives, which had impressed van Westerrode greatly when he encountered them during his holiday in Germany. Some of the principles of Raiffeisen credit cooperatives were that borrowers must be members of the cooperatives, borrowers were required to provide the guarantees of two co-signatories, and lending interest rates were far below those charged by moneylenders (Suharto 1988; Guinnane 1994; Hollis and Sweetman 1998). The *Poerwokertosche Hulp, Spaar en Landbouwcredietbank* covered a wider circle of clients than the former bank, since it provided consumptive credits not only for government employees (both indigenous Indonesian and Dutch) and but also for the common people of Purwokerto. It also offered cheap agricultural credit to indigenous farmers in Purwokerto. The bank emphasised its fund mobilisation through savings and deposits. Moreover, this new bank also had a legal status based on *Ordonnantie* 11 August 1887, *Staatsblad* No. 205. The establishment of these two banks in the late 19th century spawned the emergence of thousands of small village banks with millions of micro-borrowers in Java, Madura, Sumatra, Bali, Lombok, and Manado until the early decades of the 20th century (Suharto 1988; Djojohadikusumo 1989), as described in the following paragraphs.

At the end of the nineteenth century the Dutch administration formed village banks and paddy banks (*bank desa* and *lumbung desa*) in Java and Madura. The establishment was intended to free small farmers from the grip of usurers and to allow villagers to secure a rice advance until the following harvest. The banks were owned and managed by the village. In 1929, the Dutch colonial administration officially recognised them in its *Staatsblad* No. 357 of the Village Credit Institution Act. Nowadays, these banks are referred to as the *Badan Kredit Desa* (BKD). By the beginning of the twentieth century, there were more than 10,000 institutions in Java (especially in the rice-producing great plains, for example: Cirebon and Indramayu in West Java) (Suharto 1988, p.83).

The movement culminated in the establishment of the *Algemene Volkscredietbank* (the AVB Bank) in 1934 based on the Governors General Decree of 19 February 1934 No. 20 (*Staatsblad* No. 82), which later became *Bank Rakjat Indonesia* or People's Bank of Indonesia or simply BRI (Djojohadikusumo 1989, p.155). Djojohadikusumo states that

the bank was constituted by a transformation and amalgamation of the Dutch system of small village banks. The AVB Bank offered agricultural credit to the village banks and paddy banks (BKDs) and lent to cottage and handicraft industries and small traders. The village banks made small loans to farmers and the paddy banks gave loans of rice seed for planting. They kept their surpluses with the AVB Bank, which also supervised them. Thus, it is worth noting, as Schmit (1994) does, that the founders of *the unit desa system* pilot project for modern BRI consulted the credit manuals of the AVB Bank extensively to design the now famous *KUPEDES*[10] loan and *SIMPEDES* savings products (Schmit 1994, p.1). Evidently, the world's greatest microfinance success story (Mosley 1996a; Ledgerwood 1999; Robinson 2001), *the BRI Unit Desa System*, is firmly rooted in more than one hundred years of experience and experiments in the field. The further development and regulation of this system is discussed in the next section.

Independence Period

As noted before, the development of microfinance institutions in the colonial era inspired and encouraged the establishment and development of the institutions in the post-colonial period (independence period). This section discusses the development of microfinance institutions in the independence period, which consists of two periods: (1) the Soekarno administration (1945-1966) and (2) from the commencement of the Soeharto regime until the present time.

(1) During the Soekarno administration

During Soekarno's administration (1945-1966), especially from 1957 to 1965, the formal financial system was strongly repressed and nearly destroyed as a consequence of policies implemented by the Sukarno Government, as Cole and Slade (1996) - two scholars who have studied the Indonesian financial system intensively - have pointed out. The policies succeeded in eliminating all foreign ownership or participation in the

[10] The BRI introduced its new program of general purpose credit called *Kredit Umum Pedesaan* (KUPEDES) in early 1984 and a package of savings instruments - rural savings (SIMPEDES) and urban savings (SIMASKOT) - in 1985.

banking system and nationalising the former Dutch-owned banks. This was followed by the consolidation of the nationalised banks into one institution combining central and commercial banking functions (Cole and Slade 1996, p.9). Further, Cole and Slade also argue that the increasing reliance by the government on the Central Bank to fund most current budget expenditures, especially after 1960, led to hyperinflation which undermined public confidence in the currency and shrank the real size of the money supply to less than 4 percent of Gross Domestic Product (GDP). Moreover, Cole and Slade (1996, p.9) argue that in 1966 the Indonesian financial system, either in terms of institutional capacity or value of Indonesian financial instruments, was practically non-existent. In 1966, the economic crisis, coupled with a grave political crisis, paved the way for the violent transition, which brought General Soeharto to power (Lapenu 2001).

(2) Soeharto administration until present

One of the successes of the Soeharto regime was the establishment of a formal financial system, especially microfinance institutions, elements of which made savings and credit services accessible on a sustainable basis to a large portion of the rural population (Conroy 2000, p.97). The initial intervention phase of the Soeharto government began in 1967 with an emphasis on restoring Indonesia to financial and monetary health, primarily through combating inflation (Lapenu 2001). A second objective was to foster the growth of financial services, especially the banking sector (Cole and Slade 1996), particularly through the establishment of regional development banks (*Bank Pembangunan Daerah* or BPD). Established during the late 1960s by Soeharto administration, the BPDs operated as commercial banks run by the provincial governments (which provided them with funds as the initial capital) and helped to finance regional economic policies. As a result of these policies, one BPD is located in each provincial capital throughout Indonesia.

In addition, through Soeharto's financial policies, rural credit and funds institutions (*Lembaga Dana Kredit Pedesaan* or LDKP) were established during the period from around 1970 (the beginning of the period of economic recovery) to 1988, when the

financial reform package lifted the ban on the establishment of new banks (this is discussed in the next section). The LDKP[11] is a generic term for a variety of small savings and credit institutions which exist, with regional variations, in many provinces (Conroy 2000). In the late 1970s nearly 300 such small savings and credit institutions were established in Indonesia (Lapenu 2001, p.4). These institutions were treated as non-bank financial institutions (NBFI), a status which according to the Banking Law of 1967 (Government of Indonesia 1967) has important implications (Martokoesoemo 1994a, p.75): first, they were not eligible for liquidity credits from the Central Bank (Bank Indonesia), therefore funding had to be raised from other sources; second, they were also not allowed to mobilise funds (e.g. savings) from the public; and third, they were not bound by the interest rate regulation from the Bank Indonesia, and could therefore set their own lending rates.

The pioneer *Badan Kredit Kecamatan* (BKK) or Subdistrict Credit Board in Central Java was established by the Central Java provincial government in 1970. BKKs were conceived as credit institutions since the target group – the rural poor - were considered too poor to save and since BKK had no bank licence to mobilise savings from the public according to the 1967 Law mentioned above. However, by special permission granted by the Ministry of Finance in 1984, BKKs introduced mandatory savings in order to educate the poor to the value of savings. A few years later, the BKKs started to seriously promote voluntary savings mobilisation in order to enhance the savings habit of the rural people after being granted permission by the Ministry of Finance to do so in 1987 (Martokoesoemo 1994a, p.75; Bank Indonesia and GTZ 2000, p.20). The growth of these institutions was mainly influenced by retained earnings and initial loans from the provincial government. Mosley (1996) states that the BKKs received concessional credits from the Ministry of Finance through the Bank Indonesia, and from 1984 to 1992 from USAID under its Financial Institutions Development Programme (Hulme and Mosley 1996b, p.34). Since BKKs were not regulated by the Bank Indonesia,

[11] Bank Indonesia and GTZ (2000) state that the LDKPs are a post-colonial revival of the village bank movement, which suffered a severe setback in the late 1960s due to monetary instability and high inflation causing widespread failures of these village banks.

according to the Banking Law of 1967, they were free to set interest rates that enabled them to have enough profit to allow for substantial growth. Based on data collected by Steinwand, the study of Bank Indonesia and GTZ[12] (2000, p.21-2) reveals that in December 1998 BKKs had a total of Rp96 billion in loans outstanding in 294,000 loan accounts, and savings amounted to Rp66 billion in 440,000 accounts. This success has inspired other provincial governments to study the BKK experience and to adopt a similar approach in their provinces. Some examples of the institutions are provided below.

In 1972 the provincial government of West Java and West Sumatra established their non-bank financial institutions, the so-called *Lembaga Perkreditan Kecamatan* or LPK (Subdistrict Credit Institutions) based on the West Java Governor's Decree No. 171 of 1972, and *Lumbung Pitih Nagari* or LPN (Village Credit Organisations) based on the West Sumatra Governor's Decree No. 085 of 1972 (Danusaputro, Colter et al. 1991, p.19). In 1984 *Kredit Usaha Rakyat Kecil* or KURK (Small Rural Credit) was established by the provincial government of East Java based on the East Java Governor's Decree No. 197 of 1984, and the Bali provincial government also established *Lembaga Perkreditan Desa* or LPD (Village Credit Institutions) in the same year. At present, the LPD of Bali is considered the most successful microfinance institution in Indonesia, which has demonstrated its strength in mobilising savings from the villagers by introducing voluntary savings from the beginning (Bank Indonesia and GTZ 2000). The Bali LPD is of particular interest to this study, since it is different from other institutions in terms of ownership, regulation, and operations. Unlike other institutions, LPDs are owned by the custom village (*desa adat*)[13] and not by the provincial government. The influence of local custom in the regulation and operational arrangement of the LPD seem to be very important and it is explored in greater depth in Chapters 4 and 6 of this study.

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[12] The GTZ, which stands for *Gesellschaft für Technische Zusammenarbeit* (German Agency for Technical Assistance), is a non-profit organization from Germany.

[13] There are two different types of villages in Bali: administrative village (*desa dinas*) which is an element of government administration and custom village (*desa adat*) which is more an association of people rather than a geographical or administrative unit. This difference is elaborated in Chapter 4.

During the same period of the Soeharto era, the Government of the Republic of Indonesia (GOI) launched a program of making Indonesia self-sufficient in rice production by 1969. The program was launched primarily on Java and was intended to spur Indonesia's growth by heavily favouring agricultural development (Cole and Slade 1996; Lapenu 2001). The Government used the BRI - a state-owned bank - to carry out the credit policy, the so-called *Bimas* (Mass Guidance) credit program, as part of a broader effort to gain national self-sufficiency in rice production (Danusaputro, Suharto et al. 1991; Cole and Slade 1996; Charitonenko, Patten et al. 1998). This resulted in the BRI becoming the predominant financial institution in rural areas. The financial system's structure was dictated primarily by the extension of two major networks: the BRI's village unit system, which was mandated to distribute subsidized credit for rice production, and the KUD (village unit cooperatives), which provided technical training (mass guidance). At the peak of Village Unit establishment in 1984, the BRI had established more than 3,600 village units (*unit desa*) nationwide at the sub-district level, which were designed to channel and make loans directly to individual farmers who participated in the program (Cole and Slade 1996, p.109; Charitonenko, Patten et al. 1998, p.5).

In 1983 the Government of Indonesia decided that, after reviewing the experience of several other small-scale credit programs, the BRI Unit Desa system was to be converted into a sustainable system of commercial banking at the local level (Cole and Slade 1996, p.109; Robinson 2001, p.59). According to this new system, the BRI Unit Desa could apply a new flexibility in setting interest rates on both deposits and loans. Cole and Slade (1996) point out that the Ministry of Finance and BRI agreed on new savings and credit programs that would pay deposit rates high enough to attract savings, and charge loans rates that would be sufficient to cover both the cost of funds and operating costs.

In early 1984, the BRI began its new program of general purpose credit KUPEDES (*Kredit Umum Pedesaan*), offered throughout its village unit network (Cole and Slade

1996; Conroy 2000; Robinson 2001). Individual loans were made available to creditworthy rural borrowers for all productive purposes with a nominal monthly interest flat rate of 1.5 percent on the original loan balance (32 percent per annum effective interest rate). In 1985 a package of savings instrument – rural savings (*Simpanan Pedesaan* or SIMPEDES) and urban savings (*Simpanan Masyakarat Perkotaan* or SIMASKOT). This package provided, for the first time at the local level, the much-in-demand combination of security, convenience, liquidity, confidentiality, good service, and return (Cole and Slade 1996; Conroy 2000; Robinson 2001). It offered relatively low interest rates but permitted an unlimited number of withdrawals and provided lotteries. Creditworthy savers had access to loans, and potential borrowers could build their credit ratings with savings. According to Martokoesoemo (1994b), at the end of 1993 outstanding KUPEDES loans had grown to Rp2 trillion and SIMPEDES deposits to Rp2.7 trillion and they accounted for roughly one-sixth of the total BRI balance sheet, but they were the main source of profits of the BRI (Martokoesoemo 1994b, p.199-302).

A recent study by Patten *et al* (2001) reveals that the BRI Village Units have performed well during the Indonesian economic crisis began in the mid 1997. The study reports that in 1998 BRI's total KUPEDES outstanding was relatively stable for a year and half and prior to the crisis there was normally an increase in loans outstanding from year to year (Patten, Rosengard et al. 2001, p.1064). In terms of savings, the study also reveals that during the worst of the crisis, there was a very rapid increase in savings. In the BRI Village Units, total savings more than doubled, increasing from Rp8.3 trillion at the end of October 1997 to Rp17.9 trillion at the end of 1999. The most important thing, however, is the repayment performance. BRI Village Units also showed a high repayment performance of 97 percent until March 2000, especially for micro-enterprise borrowers (Patten, Rosengard et al. 2001, p.1063). In their conclusion, Patten *et al* (2001, p.1067) explain some reasons for the high repayment rate. First, loan products were compatible with a micro-enterprise's cash flow to facilitate loan repayment. Second, loan delivery systems were adapted to local market conditions and clientele. Third, a long-term banking relationship had developed with borrowers, characterised

by mutual respect and adherence to pre-agreed loan terms and conditions. Finally, there was un-rationed future availability of credit for present borrowers who repay their loans on time, and for new applicants who are considered creditworthy.

In October 1988, the Government of the Republic of Indonesia launched a Government Decree on banking and financial sector reforms, called *Pakto 88*.[14] Nasution (1994) highlights that the reforms included opening the industry to new entrants, removing most constraints on branching, and allowing more banks to obtain licenses for undertaking foreign exchange business (Nasution 1994, p.137). One of the important effects of the *Pakto 88* reforms was the emergence of one type of microfinance institution, the so-called people's credit bank (*Bank Perkreditan Rakyat* or BPR). In order to encourage their set-up outside urban areas for financial deepening purpose, *Pakto 88* restricted these banks to locations outside Jakarta, provincial capitals and districts (Cole and Slade 1996, p.129). They have to be located in sub-districts. *Pakto 88* however, allowed BPRs to have branch offices in the same sub-district as their head office and to conduct mobile cash units. Cole and Slade also mention that the BPR had to either be a limited liability company, a regional government enterprise or a cooperative, and it had to have an initial capital of Rp50 million.

According to *Pakto 88*, the existing BPRs - all types of non-bank financial institutions (for example: BKD, BKK, LPK, LPN, KURK, and LPD) - were given two years to adjust to the new regulations. However, by a Government Decree of March 1989 (*Pakmar 89*) the two- year time limit was eliminated in order to alleviate the difficulties faced the existing BPRs in adapting to the new regulatory structure (Government of Indonesia 1989). Thus a dual system emerged with the old style BPRs which were established before *Pakto 88* and the new style BPRs which were established after *Pakto 88* (Danusaputro, Suharto et al. 1991; Cole and Slade 1996; Bank Indonesia and GTZ 2000).

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[14] *Pakto 88* is the abbreviation of Paket Oktober 1988 (October 1988 Package of Financial Reforms).

Until the present time, according to the Banking Law of 1992 and amending legislation of 1998, there are two categories of banks in Indonesia: commercial banks (*bank umum*) and people's credit banks (Bank Perkreditan Rakyat or BPR) which is often, for traditional reasons, translated as 'rural bank' (Government of Indonesia 1992a). Commercial banks are authorised to engage in most types of normal commercial banking business, including the taking of deposits and making of loans denominated in foreign exchange and trading in foreign exchange. BPRs are basically small-scale savings banks, which are limited in terms of location, function, and portfolio composition. They are not permitted to participate in the payments clearing mechanism, which means in effect that they cannot offer their customers full cheque account facilities. The BPRs include all banks other than commercial banks. Therefore, the BPR category includes both the 1960s rural financial institutions (the old BPRs) and all newly licensed BPRs. Article 58 of the Law recognises the existence of microfinance institutions (for examples: BKDs, BKKs, LPKs, LPNs, KURKs and LPDs) and basically gives flexibility to the government to set rules for the change of status of such institutions or other organisations similar to BPRs. Further, the Law of 1992 has also shifted the role of these new BPRs from providing just rural finance, as the original BPRs did, to also providing services to economically-weak groups and small-scale entrepreneurs in urban areas (Cole and Slade 1996, p.130). The Law has broadened the location opportunities for BPRs relative to that of *Pakto 88*. The new BPRs located outside cities could open branches in capital cities of districts, provinces, and in Jakarta.

Cole and Slade (1996) argue that the Government Regulation No. 7 of 1992 following the Law did not directly address the issues posed by the different types of microfinance institutions before 1992 such as location, scope of operations and size, ownership and legal status, and supervision. However, the regulation provided flexibility for many non-bank financial institutions not to have to change, and for others to adapt to the BPR regulations within the proposed time period of five years. In addition, none of the provisions in the regulation caused serious problems for the microfinance institutions. For example, all the microfinance institutions were outside capital cities, so location

was not an issue. Scope of operation and size did not pose a problem either, because no specific minimum capital requirement was made and their scope of operations was very limited. Ownership was entirely domestic already and legal status was made flexible by article 21(2)d of the Government Regulation No. 7 of 1992. Supervision was given to the Bank Indonesia, with the Bank having some flexibility as to what kinds of requirements it wanted to set (Cole and Slade 1996, p.130).

Based on the discussion above it can be concluded that Indonesia has had a long tradition of microfinance institutions. The tradition has been developed since the colonial period and become livelier during Soeharto administration. The development of microfinance institutions specifically is aimed to help low-income people - both in rural and urban areas - to have a better access for credit from financial institutions. This access will help low-income people to develop their self-employment and income-generating activities particularly for micro and small-scale entrepreneurs and to free poor people from the grip of usurers.

3.3 THE LANDSCAPE OF MICROFINANCE INSTITUTIONS IN INDONESIA

This section attempts to present an overview of microfinance institutions configuration in Indonesia. An understanding of the institutional forms and structures of microfinance institutions would be helpful in addressing the role of microfinance institutions in economic development and their performances. This discussion only includes regulation and ownership in general, since the legislation and regulation are discussed separately in more detail in the next section.

Based on their degree of formalisation, microfinance institutions can be classified into three forms (Ledgerwood 1999, p.97). The formal institution comprises financial institutions that are chartered by the Government and are subject to regulation and supervision by the State, while the informal institution comprises intermediaries that operate outside the framework of government regulation and supervision. Between the two forms, there is the so-called semiformal institution that comprises institutions that

are not regulated by banking authorities but are registered and/or licensed by other state authorities or regional governments. Table 3.1 shows the landscape and Table 3.2 shows the size of microfinance institutions in Indonesia that are based on these forms. Regarding the structure of microfinance institutions, Bank Indonesia and GTZ (2000, p.8) state that the semiformal and informal microfinance institutions are predominant in most countries, but this is not the case for Indonesia. The frontier of microfinance in Indonesia has been pushed into the formal institutions and the formal institution has been regulated to accommodate microfinance institutions. Some financial institutions in the formal sector provide microfinance services and have a long tradition of doing so, such as BRI and village banks mentioned previously.

Table 3.1 Landscape of Microfinance Institutions in Indonesia

Formal Microfinance Institutions	Semiformal Microfinance Institutions	Informal Microfinance Institutions
Commercial Banks: ▪ BRI *Unit Desa System* ▪ Bank Dagang Bali *Rural Banks*: ▪ People's Credit Bank (BPR) *Non-bank Financial Institutions*: ▪ BKD ▪ Rural Credit Funds Institutions: BKK (Central Java), LPK (West Java), LPN (West Sumatra), KURK (East Java), LPD (Bali)	*Cooperatives:* ▪ Savings and Credit Cooperatives (KSP) ▪ Village Unit Cooperatives (KUD) *Nongovernmental organisations (NGOs):* ▪ PHBK Project (Project Linking Banks with Self-help Groups) ▪ Microcredit Project *Government projects:* ▪ The IDT Program ▪ The Prosperous Family Program	*Arisan* (Rotating Savings and Credit Associations) Individual money lenders (commercial and non-commercial) Retailers and shopkeepers

Source: composed by the author

As stated earlier, formal microfinance institutions are ruled by the government and are subject to banking (central bank) regulations and supervisions. The formal microfinance institutions in Indonesia can be classified into three groups: commercial banks (which could be state-owned or private banks), people's credit bank (BPR), and non-bank financial institutions. For commercial banks, when these banks serve smaller business, farmers, or low-income clients in general, there is potential for them to move into the microfinance sector. They serve financial services to the low-income clients usually via specialised departments or in cooperation with downstream institutions. In Indonesia, a good example of the involvement of commercial banks in microfinance is the Village Unit System of People's Bank of Indonesia (*Bank Rakyat Indonesia Unit Desa* or BRI Unit Desa). This example has been frequently discussed by scholars in literature and considered as the most successful microfinance institution in the world in term of number of savers and savings generation (Yaron 1992; Yaron 1994; Chaves and Gonzales-Vega 1996; Berenbach 1997; CGAP 1997; Charitonenko, Patten et al. 1998; Robinson 1998; Maurer 1999; Robinson 2001; Robinson 2002).

Table 3.2 Size of Microfinancial Services in Indonesia

Institutions	Number of units	Number of savers & borrowers
BRI Village Unit System	4,046	30,766,000
Rural Banks (new style BPR)	2,161	5,480,000
Nonbank financial institutions (old style BPR):	7,617	2,084,000
▪ BKD	5,345	758,000
▪ LDKP(a)	2,272	1,326,000
- BKK	778	440,000
- LPD	1,294	889,000
Cooperatives:	6,495	6,100,000
▪ Saving & Credit Cooperatives (KOSIPA)	1,160	3,050,000
▪ Village Unit Cooperatives (KUD)	5,335	3,050,000
Pawnshops	633	10,000,000
Credit Unions	1,071	296,000

Islamic Cooperatives (BMT)	3,043	1,756,000
NGOs(b)	400	200,000
Self-help groups(b)	100,000	1,000,000
Rotating Savings and Credit Association (*Arisan*)(b)	250,000	5,000,000
TOTAL(c)		72,295,000

a Estimates for all LDKP are based on LPD and BKK data
b Estimated
c Double counting is likely: members of self-help groups may participate in an *arisan* (ROSCA) and may also have a savings account with the BRI Village Unit System and a loan from a BPR.
Source: BI and GTZ (2000) and (Maurer 2004).

As discussed in the previous section, the BRI is a state-owned commercial bank and traditionally holds a special assignment from the Government of Indonesia to provide banking services to the rural areas, with particular emphasis on agricultural credit. The Bank ran a program of directed subsidised credit for rice farmers until 1983. In 1984, the BRI established the *unit desa (microbanking) system*, which was a separate profit centre within the bank. Even though this system forms an integral part of the BRI, its management has a high degree of autonomy and full accountability for the performance of the *unit desa system*. The management has a free hand in determining its interest rates and other operating policies (Charitonenko, Patten et al. 1998; Maurer 1999; Robinson 2001). A publication by the Consultative Group to Assist the Poorest (CGAP) summarises factors often cited to explain the good performance of the BRI *unit desa system* (CGAP 1997, p.6). The factors are, stable macro-economic environment, strong leadership within BRI, complete operational autonomy for the unit *desa* without any government mandates on reaching ‘lending targets’ or population groups, and clear and transparent financial reporting and accountability.

An example of a private bank involved in microfinance in Indonesia is Bank Dagang Bali (BDB). Robinson (1998) states that BDB is a small commercial bank established by I Gusti Made Oka and Sri Adnyani Oka in 1970. They are a husband and wife team who had experience as micro-entrepreneurs and informal commercial lenders. BDB operates at local level and succeeds in providing credit to a micro and small-enterprises

clientele. BDB is extremely active on the savings side of its microfinance activities and provides many services, which include its maintenance of daily routes to visit customers at home or their work place (Kimenyi, Wieland et al. 1998, p.68). According to Oka (2000), as cited by Conroy (2000, p.101), the Bank had almost 400,000 savings account with a mean value of Rp1.43 million and 9,600 loan accounts with a mean value of Rp24.1 million at the end of 1999.

Another group of formal microfinance institutions in Indonesia is BPR (*Bank Perkreditan Rakyat* or People's Credit Bank) or the new style BPR. According to the Banking Law of 1992, the term BPR is used to describe a range of small financial institutions having that status under the law, and which are subject to the direct regulation and supervision of the Central Bank (Conroy 2000). As mentioned previously, the law recognises two types of BPR: the old and new style BPR. The old style BPR refers to the BPR which were established before *Pakto* 88, and which included BKD and non-bank financial institutions such as BKK, LPN, KURK, and LPD. The new style BPR refers to the BPR which were established after *Pakto* 88.

The last group of formal microfinance institutions in Indonesia are non-bank financial institutions or the old style BPR as mentioned earlier. The institutions consist of rural credit institutions (BKD) and rural credit funds institutions (LDKP) such as BKK, LPN, KURK, and LPD. As noted previously, the former were established under Dutch rule on Java and Madura islands in the late nineteenth century as pioneer microcredit institutions, while the latter are non-bank financial institutions that were established by provincial governments in the 1970s and early 1980s. Since the Banking Law of 1992 and the Government Regulation No. 7 of 1992 recognised these rural credit funds institutions as the old style BPR, they are subject to the regulation and supervision of Bank Indonesia. As mentioned earlier, Regulation No. 7 of 1992 has provided flexibility for many of them not to have to change, and for others to adapt to the new style BPR regulations within the proposed time period of five years, which means that they were given an opportunity to upgrade themselves to that status of the new style

BPR and supervised directly by the Central Bank (Bank Indonesia).[15] However, the majority of them have either chosen not to come under the central bank supervisory umbrella, or have not met the criteria for the new style BPR such as a minimum capital requirement of Rp50 million (at that time around US $28,000).

Semi-formal microfinance institutions are authorised financial institutions usually licensed and supervised by other government agencies, but are not subject to the same general legislation as formal ones, which are governed by banking legislation (Ledgerwood 1999, p.12). These financial institutions, which vary greatly in size, typically serve clients associated by profession or geographic location. These institutions provide products and services that fall somewhere between those offered by formal and informal financial institutions. The design of their loan and savings products often borrows characteristics from both institutions. In many countries, such as Indonesia, some semiformal institutions frequently receive donor or government support through technical assistance or subsidies for their operations. Examples of these institutions are saving and credit cooperatives, nongovernmental organisations (NGOs), and some government projects or program.

In Indonesia, the Ministry of Cooperative and Small and Medium Enterprises Development owns and supervises *Koperasi Simpan Pinjam* (savings and credit cooperatives) and *Koperasi Unit Desa* (Village Unit Cooperatives Unit), which give credit to their clients/members (Lapenu 2001). However, they played a minor role as financial intermediaries due to the repressive regulation and excessive government interference under the New Order regime of former President Soeharto (Bank Indonesia and GTZ 2000, p.9). In the late 1970s, the Department of Cooperatives developed a Cooperative Rural Finance Program that attempted to offer credit for small entrepreneurs. The program started in 1979 as a small-scale experiment initiated as a bilateral technical cooperation project between Indonesia and the Netherlands located

[15] According to the Law and the Regulation, the Central Bank (Bank Indonesia) has to supervise all of the microfinance institutions in Indonesia. In practice, however, Bank Indonesia only directly supervises the new style BPR. Bank Indonesia has entered into a third party arrangement with various agencies to provide supervision for the old style BPR. This approach has been called a hybrid approach, which is discussed in more detail in the next section.

in the Department of Cooperatives. Moll and Palallo (1994) report that the program has gradually expanded to include over 100,000 rural members under the guidance of the Rural Credit Department of the cooperatives-oriented Bank Bukopin (Moll and Palallo 1994, p.315-6). Moll and Palallo state that after going through a lengthy development period during which the program received substantial subsidies, by the early 1990s it was able to run and expand without further assistance.

While in some Asian countries - for example: India, Bangladesh, and Philippines - nongovernmental organisations (NGOs) have a significant role in microfinance, they have only a limited role in Indonesia (McGuire, Conroy et al. 1998, p.148). There are two reasons that explain the limited role. First, the existence of such relatively effective rural financial institutions, such as BRI Unit Desa and other non-bank financial institutions, has inhibited the development of NGO initiatives in microfinance under the Soeharto Regime (1966-1998) (Conroy 2000, p.98). Second, the regime was suspicious of independent civil society organisations, which was reflected by some reserve felt by civil servants at all levels towards NGOs (McGuire, Conroy et al. 1998, p.148). Consequently, there was relatively little scope for NGO initiatives to emerge. The activities of NGOs in microfinance, as Conroy (2000) points out, were limited to participating as social and/or financial intermediaries in some official projects initiated with foreign assistance. He also states that NGOs were commonly involved in preparing self-help groups of the poor link with commercial banks for savings and credit activities. Financial intermediation, including the disbursement and collection of loans was rather less common. One such example is the PHBK[16] Project (Project Linking Banks with Self-help Groups). Bank Indonesia (the Central Bank), supported by the German government technical assistance agency (GTZ), took the first initiative in this field. In this, Bank Indonesia relied on the services of ‘self-help promoting institutions’ which included NGOs, to nurture the linkages between self-help groups of the poor and banks. GTZ technical support for the project phased out in 1999, but some further assistance is offered by Bank Indonesia.

[16] PHBK stands for *Pengembangan Hubungan Bank dengan Kelompok Swadaya Masyarakat*

There have also been government mass credit schemes in which institutional sustainability has not been a primary objective (Conroy 2000, p.107). Referring to the microfinance approaches to economic development discussed in Chapter 1, this credit scheme uses a welfarist approach. Several ministries (Home Affairs, National Development Planning Board, National Family Planning Coordinating Board, Agriculture, and Transmigration) have established their own approach to poverty alleviation using microcredit. However, these microcredit initiatives occurred without much coordination and were based on different philosophies, often contradicting the microfinance policies promoted for the formal microfinance institutions (Bank Indonesia and GTZ 2000). The basic difference between Bank Indonesia's policy for microfinance and the various state ministries concerns the subsidised interest rates for credit. Whereas Bank Indonesia began to eliminate its interest rate credit scheme after 1991, other government programs continued to provide loans at rates even below the bank's interest rates for savings. Bank Indonesia and GTZ (2000) argue that these programs have led to some irritations but have not undermined other microfinance institutions.
These different policies reflected the different approach of microfinance in providing credit for micro and small-enterprises (MSEs) and poor people. While Bank Indonesia's policy followed the institutionist approach with its emphasis on financial sustainability of microfinance institutions, other government programs followed the welfarist approach with its emphasis on direct poverty alleviation among the very poor. However, to some extent these two approaches were complementary. Conroy (2000) points out that despite the successes of BRI Units Desa and other microfinance institutions in extending sustainable financial services to low-income people, there remained a core group of the very poor untouched by the progress. These mass credit schemes reflected a political concern with the problem of the hardcore poor (McGuire, Conroy et al. 1998). Two major programs are provided below, based on McGuire *et al*'s work.

The first was the Presidential Instruction on the Backward Village Program (*Program Inpres Desa Tertinggal* or IDT Program), which was a scheduled program of Repelita

VI (Five Year Development Plan, 1993-1998) and commenced in 1993. The IDT Program was an inter-departmental program coordinated by BAPPENAS (the national development planning board). It was the largest government program using microcredit as a tool to eradicate poverty, which has established self-help groups in about 20,000 backward villages (Bank Indonesia and GTZ 2000). Targeting 'backward' villages, especially those on the 'Outer Islands' other than Java, Bali, and Sumatra, the Program was particularly concerned to redress regional income equalities. Among a package of infrastructure, training, and other initiatives, the Program made capital grants of Rp20 million to each backward village to fund income-generating activities of the poor, who were organized into groups. Loans were made at the highly subsidised rate of six percent flat per annum to finance borrowers (Conroy 2000). The capital injection of US $600 million was distributed over three years (1994-1997) to stimulate economic activity in the chosen village. The outreach of the Program has been impressive. At the end of 1996 some 107,000 self-help groups had been created, involving almost 2.9 million people. By March 1997 this number was reported to have grown to more that 120,000 groups and 3.3 million people. In short, the Program has succeeded in terms of expansion of access of the poor to microfinance. However, in terms of institutional viability and sustainability the Program did not show an outstanding performance. An evaluation of the groups by Sayogyo (1996), as cited by McGuire et al (1998), reports that after three years of IDT funding, only one third of the groups were adequately prepared for entry to the Bank Indonesia PHBK linkage project (McGuire, Conroy et al. 1998).

In 1996, as an emergency response to political concerns about income inequality, President Soeharto launched the Prosperous Family Program using the National Family Planning Coordinating Board (*Badan Koordinasi Keluarga Berencana Nasional* or BKKBN)[17] as the implementing agency (Conroy 2000). This scheme had a number of financial components, including the Prosperous Family Savings Scheme (*Tabungan Kesejahteraan Rakyat* or *Takesra*) and the Prosperous Family Credit Scheme (*Kredit*

[17] BKKBN is an agency of the government of Indonesia with an international reputation for the sustained effectiveness of its family planning program, which is credited with substantially reducing the rate of population growth over the last three decades.

Untuk Kesejahteraan Rakyat or *Kukesra*) (McGuire *et al* 1998). This program operates through women's group (Robinson 2002, p.105).

Several million Indonesian families received highly subsidized funding under this scheme over 12 months and the beneficiaries of the program were mostly women (McGuire, Conroy et al. 1998, p.159). McGuire *et al* argue that it was an extraordinary administrative and logistics achievement, accomplished in just 12 months. Both the Prosperous Family and the IDT programs were financed by a levy of 2 percent on the incomes of corporations and high-income individuals, channelled through one of the Soeharto family foundations. The Prosperous Family Program was essentially a populist response to resentment of the perceived wealth of certain groups within Indonesian society. However, the program operated on a subsidised interest rate indicating that financing under the program was not sustainable (McGuire, Conroy et al. 1998). Robinson (2002, p.105) also points out that this program was an unsustainable microfinance program which emphasised short-term political priorities at the expense of viable microfinance development. Moreover, its large scale delivery of highly subsidised credit put the program in unfair competition with the BPRs and BRI's Unit Desa.

The third form of microfinance institution is informal financial institutions. These institutions operate outside the structure of government regulation and supervision (Ledgerwood 1999). Informal microfinance comes in many forms and not always in one that can be called a financial institution. The forms of informal microfinance, which still flourish in developing countries, can be classified into four broad categories (Bouman 1990; Ghate 1992a; Ghate 1992b; Montiel, Agenor et al. 1993). The first is direct but intermittent lending by individuals or institutions (firms) with a temporary surplus of funds, which are called intermittent lenders. In the past, the lenders - such as friends and relatives (family, neighbours, or colleagues) - account for a considerable share of informal finance in most Asian countries, including Indonesia. These are uncollateralised personal loans and generally interest free (Lapenu 2001).

The second category is lending by individuals, or institutions specializing in lending, whether on the basis of their own funds or on intermediated funds. This category consists of professional money-lenders, pawnbrokers (*gadai* in Indonesia), indigenous bankers, and finance companies that make untied loans (untied credit). The third category is lending by lenders, whose main activities lies in markets other than credit but who tie credit transactions to transactions in these other markets (tied credit or interlinked). This tied credit is credit transactions that take place between borrowers, and lenders are connected in an essential way with simultaneous transactions in other markets. In Indonesia the lenders include the landlords who lend to their tenants, employers in the labour market, traders/retailers (e.g. raw material suppliers, fertilizer dealers) or buyers (e.g. rice millers, produce traders) in product markets, shopkeepers, and owners of very small restaurants (*warung*) who may extend credit to their customers (Bouman and Moll 1992; Lapenu 2001).

The fourth category is group finance where individuals pool their savings, and lend exclusively or primarily to each other (members of the group), or to persons outside the group (non-members). The groups are made up of individuals who regularly or irregularly deposit funds with a group leader. An important form of group finance is rotating savings and credit associations (ROSCAs), and known as *arisan* in Indonesia (Lapenu 2001). The *arisan*, the Indonesian name for ROSCA, primarily take the form of neighbourhood groups of 10 to 40 people (mainly women) organised into cooperative groups (in which each participant receives the amount contributed) or commercial ROSCAs (in which the ROSCA's organiser collects a management fee). They are spread all over the country. The *arisan* also play a key social role. For example, neighbourhood women may organise events in connection with religious ceremonies, such as the feast of Ramadan, at an *arisan* meeting. In other developing countries, the ROSCAs are also known as *paluwagan* in the Philippines, *kou* in Japan, *chits* funds in India, *pia-hueys* and *chaer* in Thailand, *kye* in Korea, and *byau hwei* in Taiwan. *Hui* among Chinese and Vietnamese, *Ikub* in Ethiophia, and *Ke* societies among Korean migrants in the USA (Bouman 1990; Bouman and Moll 1992; Izumida 1992).

Finally, a more developed form of informal financial institutions in Indonesia is the various types of self-help groups (*Kelompok Swadaya Masyarakat* or KSM) (Bank Indonesia and GTZ 2000). Based on the monitoring of the two largest national projects (PHBK and P4K), Bank Indonesia and GTZ (2000) estimate that there are more than 50,000 self-help groups that have reached bankability and have had at least one bank credit.

In short, this landscape of microfinance in Indonesia confirms the statement by Robinson (2002, p.83) that Indonesia is "home to the world's largest financial self-sufficient microbanking system and many smaller commercial microfinance institutions", which are in terms of scale, variety, and volume, market penetration, and profitability the most developed in the world (Berenbach 1997).

3.4 LEGISLATION, REGULATION, AND SUPERVISION OF MICROFINANCE INSTITUTIONS IN INDONESIA

Legislation and regulation of financial institutions refer to the legal framework and governing principles[18] of financial intermediation in a country. The legal framework includes defining the roles of its banking authorities (for instance: central bank, Ministry of Finance, and bank superintendency), setting out rules for entry and exit of various types of financial institutions, determining and limiting their businesses and products and specifying criteria and standards for the sound and sustainable operation of the industry (Bank Indonesia and GTZ 2000). Regulation is not limited to rules set by the state only, but may include forms of self-regulation by networks, associations, or apex organizations. Prudential regulation refers to the set of general principles or legal rules that aim to contribute to the stable and efficient performance of financial institutions and markets (Chaves and Gonzales-Vega 1994). Chaves and Gonzales-Vega suggest that the rules represent constraints placed on the actions of financial intermediaries to ensure the safety and soundness of the system. Supervision

[18] Referring to the definition of institutions discussed in Chapter 2, these legal framework and governing principles are classified as formal institutions.

encompasses all means by which the regulators enforce compliance to a given legal and regulatory framework.

In general, the regulation of financial institutions is explained as a response to the need for systems to maximise the mobilisation of funds, enhance efficiency in the allocation of capital, ensure appropriate risk management, and protect depositors (Meagher 2002). For traditional financial institutions, however, the principal rationale for regulating and supervising is consumer protection, primarily but not exclusively in the form of public depositors (Besley 1994; Chaves and Gonzales-Vega 1994). Chaves and Gonzales-Vega point out that the fact that fixed-value deposit claims are backed by risky loans makes the regulation and supervision of financial intermediaries necessary. Imperfections in financial markets, as discussed in Chapter 2, arise from asymmetries of information among depositors, the financial institution, and borrowers about the likelihood of the promises being kept. Depositors cannot know as much as financial intermediaries about the safety of their deposits, and financial intermediaries cannot know as much as borrowers about the likelihood of loans being repaid. Chaves and Gonzales-Vega (1994) emphasise that most, if not all, valid arguments in favour of the regulation of financial markets can ultimately be traced to combinations of these elements.

There are two approaches to regulating microfinance institutions operations (Greuning, Gallardo et al. 1998). The first approach is internal regulation through governance. This approach can be viewed as a framework of checks and balances designed to ensure that no party or parties within a microfinance institution impede the attainment of corporate objectives by diverting its resources for private gain. Effective governance depends on a carefully designed system, which links shareholders/members/donors to the board of directors or trustees, to executive management, the staff and clients, and the public. The linkages among the key players become increasingly important because microfinance institutions are an integral part of the total financial system.

Greuning *et al* (1998) suggest the shareholders or members are responsible for appointing the board of directors or trustees, officers in executive management, the audit committee, and external auditors, and ultimately determine the direction and business of an institution. Microfinance institutions are different from non-financial companies in that the loyalties of management and the board should be not only to shareholders and/or donors, but also to depositors and other sources of funds, who provide the leverage to institutional capital. Depositors are different from normal trade creditors because the acceptance of funds from depositors carries a fiduciary responsibility, which is different from the obligation under commercial borrowing. Greuning *et al* (1998) also point out that the risk management process through internal governance is a joint responsibility of the executive management together with the board and its audit committee and internal auditors. External auditors can complement and strengthen the internal risk management processes through audit programs that are oriented to risk analysis and assessment, rather than limited to traditional balance sheet and income statement audit examinations. For microfinance institutions that are subject to prudential supervision, external auditors can assist significantly in optimizing the external risk management process through proper coordination and liaison with supervision examiners and internal auditors.

The second approach is external regulation by a supervisory agency. Since the interests of the financial institution and the interests of the consumer are not congruent *per se* – leading to moral hazard – and because the individual depositor/investor is not in a position to judge the soundness of a financial institution – adverse information – nor to influence its management, an impartial third party is required to regulate and control the soundness of a country's financial institutions. This is called the 'tiered banking' structure approach in which a range of financial intermediaries is licensed by the regulatory banking authority (central bank) to provide banking and financial services to the public (Greuning, Gallardo et al. 1998; Bank Indonesia and GTZ 2000; Meagher 2002). The licenses granted specify limits to the types of services that may be offered, as well as the prudential guidelines to be observed. Small, specialized or limited banks

coexist with large universal or multiple banks in a 'tiered banking' structure which remains under the jurisdiction of the regulatory bank authority.

Greuning *et al* (1998) also suggest that the bank supervisors, deposit insurance companies and securities regulators become involved in the external risk management process for regulated microfinance institutions because of the compelling interest of the government in the soundness and stability of the banking and financial system for the sake of the rest of the economy. However, it needs to be clearly understood that (1) external supervisors and regulators cannot prevent regulated and licensed institutions from failing, and (2) as facilitators of the risk management process, supervisors and regulators must evaluate and enhance the statutory framework under which risk management is carried out by regulated and supervised microfinance institutions.

In Indonesia, based on the Banking Law of 1992 and amending legislation of 1998, all banks were supervised by the central bank (Bank Indonesia) until the year 2002,[19] when a new bank supervisory agency was to be created and to take over from Bank Indonesia. In practice, however, while the Bank Indonesia has the legal responsibility to supervise all microfinance institutions, it only directly supervises BPR (the new style BPR). This is partly because a limited number of supervisors available from Bank Indonesia relative to the number of microfinance institutions, and Bank Indonesia realises that it is impractical and a very expensive task to supervise thousands of BPR (Bank Indonesia and GTZ 2000). Therefore, as shown in Table 3.3, Bank Indonesia has entered into a third party arrangement with various agencies to provide microfinance with direct supervision, including on site audit (Berenbach 1997). This approach, as mentioned earlier, has been referred to in the literature as a multi-agency and tiered regulatory framework and a so-called hybrid approach (Greuning, Gallardo et al. 1998; Meagher 2002) which is explained below.

[19] According to the Central Bank Law No. 23 of 1999, Bank Indonesia has to transfer the task of bank supervision of all banks to a new bank supervisory agency by the year 2002. However, the agency had not been created by the time this study was completed (late 2004).

Table 3.3 Supervisory Arrangements of Microfinance Institutions in Indonesia

Institutions	Supervisory Body
▪ BRI Village Units	BRI Village Unit Division
▪ BKD (village-owned banks)	BRI Small & Cooperative Division
▪ Non-bank Financial Institutions (LDKP)	Provincial Development Banks (BPD)
▪ BPR (People's Credit Banks)	Bank Indonesia

Source: Berenbach (1997) and Bank Indonesia and GTZ (2000)

The following section discusses the regulations for some microfinance institutions in Indonesia and the organisations involved in and responsible for the supervision and guidance for the institutions. This discussion is valuable in assessing the role of formal regulations and some organisations in fostering the growth of microfinance institutions in Indonesia. The discussion starts with the BRI Unit Desa system.

Regulation and supervision for the Bank BRI Unit Desa

BRI Unit Desa is a division within the BRI, a commercial state-owned bank regulated under the banking law and supervised by Bank Indonesia. Within BRI, the Unit Division is responsible for overseeing the whole unit *desa* network, which operates independently of BRI's branch system. Supervision of the unit *desa* is undertaken by two managers of the Unit Division placed in each BRI branch and reporting directly to the branch manager (Berenbach 1997). The Unit Desa manager is responsible for visiting each unit once a week (on-site supervision) to verify reports. The Unit *Desa* report daily (trial balance), weekly (liquidity report), monthly (progress report, balance sheet, income statement), quarterly (personnel report), semi-annually (past performance indicators for contest achievement) and annually (balance sheet and income statement) to the supervising branch, regional and head office.

Table 3.4 BRI Village Unit Loan Classification and Reserves

Loan Classification	Delinquency	Loan Loss Reserves: 3% Total Portfolio
▪ 'Before Due'	Late payment	0%
▪ Substandard	Up to 3 months	50%
▪ Doubtful	3-9 months	100%
▪ Bad-debt	9-12 months	100%
▪ Write-off	Above 12 months	100%

Source: Berenbach (1997)

According to Berenbach (1997), the loan classification and reserve system — as shown in Table 3.4 — is relatively more conservative than Bank Indonesia's criteria for BPR. As shown in the table, loans of up to ninety days late are classified as substandard and require a fifty percent provision, loans longer than three months overdue require a one hundred percent provision, and a complete write-off occurs after twelve months.

Regulation and supervision of People's Credit Bank (BPR)

The Banking Law of 1992 regulates all banks with a BPR license. In November 1998, the law was revised by the Banking Law of 1998, giving more power to Bank Indonesia as the regulatory and licensing authority, the latter of which was formerly with the Ministry of Finance (Bank Indonesia and GTZ 2000). However, the basic regulations governing BPR remained unchanged, except that all banks (commercial and people's credit banks) are now required to participate in a deposit protection scheme. The banking law recognizes only two types of banks: the commercial banks or primary banks (Bank Umum) and the people's credit banks or secondary banks (*Bank Perkreditan Rakyat* or BPR). The fundamental difference between commercial banks and BPR is that the latter are excluded from the payment system, as they are not allowed to offer checking accounts. All banks are subject to supervision by Bank Indonesia. Supervision of BPR was an issue at the time the Banking Act was prepared. It was felt that Bank Indonesia should assume full supervisory responsibility of the entire banking sector, however, it was recognized that the supervision of thousands of

BPR would be a cumbersome and expensive task with limited payoff in protecting the stability of the whole financial system (Bank Indonesia and GTZ 2000). Some of the BPR perform exceptionally well, others perform poorly, and many are in between (Robinson 2002).

In May 1999 Bank Indonesia issued a set of new regulations. The new regulations allow BPR to operate in urban areas but increases the minimum capital requirements for new BPR in the wider area of Jakarta (Jabotabek) to Rp2 billion, in other provincial capitals to Rp1 billion, and to Rp500 million in all other areas. In addition, the existing BPR were required to hire two managers, for the purposes of internal control, with at least a diploma 3 (D3) level and two years operational banking experience. It is the overt policy of Bank Indonesia to raise the entry barrier for new BPRs because Bank Indonesia envisages having fewer but larger BPRs in the future. It was intended that by the year 2002, when Bank Indonesia intended to hand over supervision to the new supervisory agency, all BPR should be sound. To achieve this goal, Bank Indonesia and GTZ have jointly developed a pilot project under the name ProFI that is providing technical assistance for strengthening and capacity building small financial institutions (Bank Indonesia and GTZ 2000). This project is continuing at the time when this thesis was being completed.

Prudential regulation, supervision, and reporting requirements for BPR are similar to those for commercial banks. Bank Indonesia has simplified and adapted the CAMEL (Capital, Assets, Management, Earnings, Liquidity)[20] tool for commercial banks to the requirements of BPRs. BPRs are classified into four categories: sound, fairly sound, less sound and unsound. The rating is based on off-site supervision by analyzing standardized and computerized monthly reports prepared by the banks (balance sheet, loss and profit, loan classification). On-site supervision is ideally undertaken once a year per BPR to verify reports and check on management. However, in practice, on-site supervision is undertaken less than once a year per BPR due to limited bank supervisory staff in Bank Indonesia. Bank supervision is fully decentralized and

[20] The calculation method of CAMEL rating is in Appendix 2.

executed by Bank Indonesia offices in every province. The respective Bank Indonesia office prepares the CAMEL rating. The directorate of BPR supervision in Jakarta collects all reports from the provinces and prepares aggregate figures for the whole industry. It decides on withdrawal and issuing of new licenses for BPR after consultation with the Bank Indonesia office in each province.

The BPR regime seems to be unique in the world of microfinance. The Indonesian government has explicitly recognized the importance of microfinance and has provided a competitive regulatory framework. This has greatly facilitated entry into this market and has based microfinance on firm commercial grounds rather than on continued donor support. However, the rapid growth of the industry coupled with shortcomings in the supervision of BPR have led to a high percentage of unsound BPRs, which are now on the brink of collapse because of mismanagement and will eventually have to be bailed out under the government's deposit guarantee. Improved supervision is thus required to guarantee the quality of people's credit banks and preventing them from becoming insolvent. An effective and efficient supervision is a must and *a conditio sine qua non* for the functioning of a future deposit protection scheme to be based on self-financing rather than on government bailouts. To improve the situation, Bank Indonesia with the support of GTZ (Bank Indonesia and GTZ 2000) has embarked on some policies to strengthen village banks. First, deposit protection is mandated for all banks by the revised Banking Act of 1998. For BPRs, it is proposed that a private limited liability company be established that is jointly owned by Bank Indonesia and the Association of Rural Credit Banks (*Persatuan Bank BPR seluruh Indonesia* or *Perbarindo*). A simple but effective risk rating instrument is going to be developed to assess fees and monitor member banks. Second, in the field of human resources development, a diploma for BPR managers will be considered as part of the 'fit and proper test' for future BPR managers.

The third policy plank focuses on improving bank supervision. The current practice and tools of bank supervision will be thoroughly reviewed and revised. The ProFI project is exploring the possibility of introducing the concept of risk rating as an alternative to the

present CAMEL tool applied to BPR supervision. The BPR CAMEL tool has been criticized for not adequately reflecting the status of the main asset of a BPR, i.e., its loan portfolio (Bank Indonesia and GTZ 2000). Loan classification might need to be reviewed and made more stringent. More frequent on-site reviews are required to undertake well-organized and systematic portfolio audits. Liquidity requirements appear to be rather low for unsophisticated BPRs with a term structure dominated by few but relatively large deposits and a large number of relatively small saving accounts that can be withdrawn without notice. Cash-flow based liquidity management is required but a standardized instrument is not yet available.

Strengthening the BPR association through the newly formed Perbarindo is the fourth strategy to strengthen microbanks. Self-regulation is clearly an issue, but not much has been done so far to stimulate it. The Perbarindo is expected to be the ideal institution to complement Bank Indonesia's supervisory function with increased self-regulation. However, Perbarindo still has a long way to go to qualify itself in the eyes of member banks as well as the central bank before it could be entrusted with such a task.

Regulation and supervision of non-bank financial Institutions

As stated previously, non-bank financial institutions consisting of rural credit institutions (BKD) and rural credit funds institutions (LDKP), which are classified as the old style BPR, are also subject to the Banking Law. However, their supervision is conducted by agencies other than the central bank. While in principle responsibility for the BKD's supervision resides with the central bank, they are actually supervised by BRI, continuing an old tradition dating back to BRI's predecessor (the AVB Bank) and considering their large number and the fact that the BKDs are not mobilising deposits from the public (Bank Indonesia and GTZ 2000). However, the central bank pays BRI for this service.

The LDKP– such as BKK, LPN, LPK, KURK, and LPD- are closely related to their respective provincial governments. As mentioned earlier, most of them were established in the 1970s and early 1980s and owned by provincial governments. The

central bank entrusted the provincial governments and the regional development banks (BPDs) with the supervision. BPDs also provide technical assistance. However, the quality of this supervision and technical guidance varies greatly from province to province since the quality of the respective regional development banks varies. A good example here is the LPD of Bali which is discussed in the following section.

Regulation and supervision of cooperatives and NGOs

Other microfinance institutions such as cooperatives and nongovernmental organisations (NGO) are regulated by other agencies. Credit activities of cooperatives are regulated by the Department of Cooperatives and Small and Medium Enterprises Development. Cooperatives have a special place in the Indonesian national ideology. According to the Indonesian Constitution (article 36), cooperatives will be one pillar of the national economy. Hence, the government sponsored Village Unit Cooperative (KUD) gained much attention and support during the Soeharto administration and was established all over the country. The Cooperatives Law of 1992 entrenches the role of KUD and their continuing claim on government resources (McGuire, Conroy et al. 1998). However, cooperatives still play a minor role in the field of microfinance in Indonesia, as mentioned earlier, due to repressive regulation and excessive government interference under the Soeharto regime (Bank Indonesia and GTZ 2000).

As discussed earlier, nongovernmental organisations (NGOs) had only a limited role in Indonesia until present time. There was a little direct support provided by the government for independent microfinance activities in Indonesia. Some individual NGOs have links with international NGOs which have brought limited funding and know-how from overseas (McGuire, Conroy et al. 1998). Supervision was minimal under the Soeharto regime unless an NGO attracted political attention. NGOs conducting microfinance are allowed to offer credit, and there are no reporting requirements or supervisory arrangements for such activities. However, they are not allowed to mobilize the savings from their members unless the savings are deposited directly in a regulated financial institution. Some savings mobilisation have been

tolerated as long as the amount was small, and some larger NGOs have established their own BPR to overcome the problem (Conroy 2000).

As a final note in this section, in 2004 Indonesia is in the process of developing a microfinance law. One of the aims of this Law is to facilitate the implementation of Regional Government Law No. 22/1999 and give local government greater powers to protect small savers, and to optimise microfinance institutions' performances in order to enhance the economic capacity of low-income people. The draft of the Law of Microfinance provides for a regulatory structure for BKDs, rural credit funds institutions (LDKPs), and NGOs (but not cooperatives) engaged in microfinance, defined as mobilization of funds and provision of small loans primarily to low-income persons and groups engaged in microenterprise (Anonymous 2001). The draft covers gaps in the existing regulations requiring registration and compliance by all microfinance institutions that have mobilized aggregate funds in excess of Rp50 million – this includes all savings, both public deposits (including term deposits) and member savings. Microfinance institutions that mobilize funds in excess of Rp1 billion must obtain a people's credit bank (BPR) license. Microfinance institutions must be wholly Indonesian-owned (and entirely Indonesian-staffed), whether by individuals (minimum number per microfinance institution: 20 people), companies, associations, or local governments. The supervising institution for microfinance institutions (*Lembaga Pengawas Jasa Keuangan* or Institutions for Financial Services Supervision) may delegate both licensing and supervision of microfinance institutions to provincial governors, commercial banks, or others. However, the new law is still in draft stage in 2004.

3.5 SUMMARY

Microfinance institutions as development tools and financial intermediaries have been active in Indonesia since the colonial period until the present time. However, their development experienced rises and falls. During the colonial period, microfinance

institutions grew very rapidly all over the country. The establishment was mainly intended to free small farmers from the grip of usurers and to allow villagers to secure a rice advance until the following harvest. But in the first phase of the independence period – during the Soekarno administration (1945-1966) – the development of financial institutions in general was stagnant. This was partly because the formal financial system was strongly repressed and nearly destroyed as a consequence of policies implemented by the Sukarno Government (Cole and Slade 1996).

In contrast, in the era of President Soeharto, the development of microfinance institutions received a great deal of attention from government. Economic development strategies developed by the Soeharto regime - including the development of the financial institutions system - has encouraged the development of microfinance institutions. Some legislation and deregulation policies such as the Banking Law of 1967, the deregulation package of October 1988 (Pakto 88), the Banking Law of 1992 and amending legislation of 1998, and the Government Regulation No. 7/1992 have fostered the rapid development of microfinance institutions in Indonesia.

By the year 2000, there were hundreds of thousands of microfinance institutions in Indonesia, which can be classified into three forms. First, formal institutions which consist of commercial banks (which could be state-owned or private banks), people's credit bank (BPR), and non-bank financial institutions (for examples: BKK, LPN, KURK, and LPD). The second form is semi formal institutions such as saving and credit cooperatives (Koperasi Simpan Pinjam or KSP), non-governmental organisations (NGOs), and some government projects or programs. The third form is informal microfinance institutions such as intermittent lenders (family, neighbours, or colleagues), *gadai* (pawnbrokers), and *arisan* (rotating savings and credit associations), and Kelompok Swadaya Masyarakat or KSM (self-help groups).

In sum, the discussion in this chapter has revealed the history and importance of microfinance institutions in Indonesia since the colonial period until the present time. The discussion indicates that although the regulations and supervision for the

institutions slightly vary from one to another microfinance institution, it can be inferred that the Central Bank (Bank Indonesia), the Government (at central and provincial level), and commercial banks (such as Bank BRI and Bank BPD) have played a central role in fostering the rapid growth and enhancing the development of microfinance institutions in Indonesia through their regulations (formal regulations) and supervision. In addition, this chapter also has also indicated the relationship between macroeconomic conditions and the growth of microfinance institutions in Indonesia, providing useful insights in assessing the influence of the formal regulations (formal institutions) and macroeconomic conditions in particular on the performance and sustainability of the Village Credit Institutions of Bali (*Lembaga Perkreditan Desa* or LPD). This will be discussed in Chapters 6 and 7 of this study.

CHAPTER FOUR

THE SOCIO-ECONOMIC ENVIRONMENT OF BALI

4.1 INTRODUCTION

Socio-economic characteristics of an environment are an important factor in the success of microfinance institutions (Chaves and Gonzales-Vega 1996; Snow 1999; Franks 2000; Robinson 2001). A dynamic economy and macroeconomic stability can offer an auspicious climate for financial intermediation. In addition, political stability, a strong presence of government at all administrative levels, a high degree of social cohesion, and the importance of traditional social structures have offered effective mechanisms for financial contract enforcement.

This chapter explores the contention of the scholars mentioned above that socio-economic characteristics of an environment have been important factors in the success of microfinance institutions, using Bali as a case study. Bali is a good case because this province has unique cultural and social institutions that are rooted in two basic interrelated systems: (1) the extended family, community (*banjar*) and the ancestor systems, and (2) the Balinese Hindu religion (Jensen and Suryani 1992). Moreover, Jensen and Suryani (1992) also argue that these socio-cultural aspects are so elemental and pervasive that they can be regarded as the fundamental forces shaping the behaviour and character of the Balinese people. Following a brief description of the geographical and demographic features of Bali, the chapter provides an outline of the government administration, with particular emphasis on the influence of central government regulations on local government economic development policy. The rationale for this is that political stability, strong presence of government at all

administrative levels, a high degree of social cohesion, and traditional social structures, have offered effective mechanisms for financial contract enforcement. Since Bali's microfinance institutions are based in the custom village (*desa adat*), the chapter initially focuses on the relationship between Hinduism and custom village, and the role of custom village and hamlet (*banjar*) in the daily social life of the Balinese. As a dynamic economy and macroeconomic stability can offer an auspicious climate for financial intermediation, the chapter also seeks to identify the macroeconomic conditions that have fostered the development of LPDs in Bali. Together, these following sections provide the background against which the performance and sustainability of Village Credit Institutions (LPDs) of Bali can be assessed.

4.2 GEOGRAPHIC AND DEMOGRAPHIC CONDITIONS

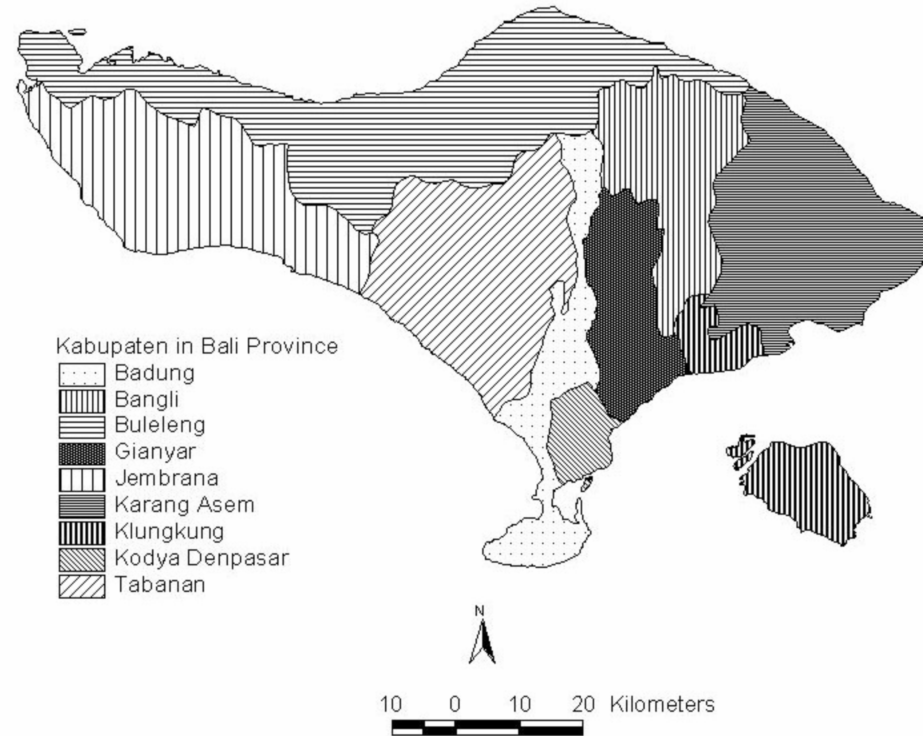
Bali province consists of several islands, which include Bali Island, Nusa Penida, Nusa Ceningan, Nusa Lembongan and Serangan. The province is located midway along the string of islands which makes up the Indonesian archipelago, stretching from Sumatra in the Northwest, to Papua, in the Southeast (see Figure 4.1). Bali province is bordered by the Indian Ocean to the South, Java Sea to the North, Bali Strait to the West, and Lombok Island to the East. Bali is divided into the city of Denpasar and 8 districts. The smallest area of this province is the city of Denpasar with an area of 123.98 sq. km, while the largest area is Buleleng district with an area of 1,365.88 sq. km (see Figure 4.2).

With regard to the agricultural regions, most of the paddy fields in Bali are located in the coastal plains of the south and rise toward the mountain terraces contoured to fit curves of the terrain. Picard (1996, p.13) points out that the fertility of the soil and organisational skill of the Balinese enabled them to develop, very early in their history, a highly productive irrigated rice culture. The irrigation infrastructure and distribution of water among the paddy fields are carried out by irrigation societies, the so-called *subak*. The main task of the *subak* – sometimes translated as 'agricultural society' – is to run the irrigation system essential for growing paddy. Daroesman (1973) argues that

from an economic point of view, these are the most important of all autonomous organisations operating within or among the Balinese. The *subak* were reported to be in existence in 11th century, and were described in some detail by Cornelius Houtman in 1597 (Daroesman 1973, p.47). The membership of the *subak* is comprised of the owners, tenants and sharecroppers of the paddy fields within its area. Because the *subak* were also charged with tending temples involved in the worship of the gods of farming, they have been described as basically a temple group by some commentators (Mabbet 1985; Covarrubias 1986). But the *subak* is also directly involved in the farming program, particularly in the release and control of water to farmers who pay the *subak* according to the quantities supplied.

Figure 4.1 Map of Indonesia

Figure 4.2 Map of Bali Province and Its Administrative Subdivisions



At the beginning of the 20th century, when the population was less than one million, Balinese rice production was productive enough to nourish the population (Picard 1996, p.13). Today more than three million people inhabit the island, as shown in Table 4.1. Bali's average population density was 541 people per square kilometre in 2001, making it the most densely populated province outside Java. The highest population densities (more than 750 inhabitants per km2) exist in the southern districts such as Denpasar city (3,378), Gianyar district (1,007), and Badung district (781). This is partly - as noted earlier - because this southern part is the heart of Balinese culture and the most fertile region in Bali.

Under the pressure of a growing population, landed property was broken up and then the paddy fields became insufficient to support the farmers and their families. In the absence of mineral deposits, limited infrastructure and land suitable for large plantations and industrialisation, but with the richness of Bali's cultural attractions - such as Balinese dance and ritual ceremonies - and the beauty of its landscape, tourism development seemed to be a good solution to raise the living standard of the Balinese without forcing them to renounce their traditional culture (Picard 1996, p.13-14). A discussion of the development of Bali tourism is presented in section 4.4.

Table 4.1 Land Area, Population, and Population Density of Bali Province by City/Districts, 2001

City/Districts	Land area (square km.)	Population	Population density per square km.
Denpasar	123.98	418,791	3,378
Badung	418.52	327,206	781
Gianyar	368.00	370,788	1,007
Jembrana	841.80	216,343	257
Tabanan	839.30	386,850	460
Klungkung	315.00	165,815	526
Bangli	520.81	198,801	237
Karangasem	839.54	378,800	451
Buleleng	1,365.88	584,923	428
	5,632.83	**3,048,317**	**541**

Source: CBS-Bali, Bali in Figures 2001

4.3 GOVERNMENT ADMINISTRATION SYSTEM

This section discusses the government administration system in Indonesia in general and its relationship to the province of Bali in particular. This discussion aims to reveal the influence of the central government regulations on regional (local) government economic development policy, particularly on Bali province. The discussion starts with the form of the Indonesian state, which has been under continuous discussion throughout Indonesia's history. Nasution (2002) points out that the discussion indicates that the process of nation building is not yet complete and suggests that there are two primary factors complicating the determination of the Indonesian state (Nasution 2002, p.38). First, historians reveal that Dutch governance during the colonial occupation emphasised the principle of unity. The nation's founding fathers recognised the vastness of the Indonesian archipelago and agreed with the colonial Dutch concept of geopolitical unity. This experience is firmly rooted in Indonesia's history. Second, although the Dutch put forth the concept of federalism during the struggle for Indonesia independence, their underlying motivation in doing so was purely to maintain their power in the region. This tactic was employed by the last Dutch Governor General, Van Mook, to create division within the nation, and was in itself laced with antipathy towards nationalist figures and Indonesian society in general. These two factors always arise during any debate over the appropriate form of governance in Indonesia.

Harun Al-Rasid[21] (2002) points out that before independence and in the early period of independence, the choice of state form was debated by the founding fathers of the Republic of Indonesia (Al-Rasid 2002, p.141-2). They were divided into two camps. In one, Hatta (the first Vice President of the Republic of Indonesia), Soetisna Sendjaja, and Anwar Sutan Amiruddin were proponents of a federal state; while in the other Supomo, Mohammad Yamin, and Soekarno were proponents of a unitary state (Samudra 2000). However, after a long and heated debate in the plenary session of the Investigation Committee for the Preparation of Indonesia's Independent (*Badan*

[21] He is a well-known Constitutional Law Professor at the University of Indonesia.

Penyelidik Untuk Persiapan Kemerdekaan Indonesia or BPUPKI)[22] on 10 and 11 July 1945, they finally agreed to choose the unitary state as the form of the Republic of Indonesia in 1945. Al-Rasid (2002, p.142) states that in the plenary session of the BPUPKI on 14 July 1945, Soepomo, in his role as the head of the Sub-committee on Constitution Drafting, said that the concept of a unitary state was laid down in Article 1 (and verse 1) of the Constitution of the Republic of Indonesia of 1945. The founding fathers considered that the unitary state was the best choice to unite Indonesia as one to reduce the ethnocentrism and insularism of the Indonesian people.

However, Indonesia also had a short period as a federal state system during 1949-1950. After Indonesia proclaimed its independence in 1945, there was an Indonesian national revolution from 1945 to 1949[23] that was mainly caused by the Dutch military actions[24] trying to maintain its influence on the Indonesian state (Reid 1974, p.162-165; Ricklefs 1993, p.232-233). The revolution ended with the conducting of a Round Table Conference from 23 August to 2 November 1949, which was attended by the Indonesian government and the Dutch government, in The Hague in the Netherlands. One of the agreements achieved from the Round Table Conference was that the Unitary State of Indonesia became the Federal State of Indonesia (officially known as the *Republik Indonesia Serikat* or simply RIS) based on a new constitution, the so-called the Constitution of the Federal State of Indonesia.[25] However, in 1950 the Dutch-imposed federal system collapsed and the Indonesian government returned to the concept of a unitary state as envisioned at the time of the declaration of independence the Constitution of the Republic of Indonesia of 1945 (Reid 1974,p. 162-165; Ricklefs 1993, p.232-233; Rohdewohld 1995, p.8).

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[22] The Investigation Committee for the Preparation of Indonesia's Independence (*Badan Penyelidik Untuk Persiapan Kemerdekaan Indonesia* or *Dokoritsu Zyunbi Chosakai* in Japanese) was a body which consisted of 69 members, established by the Japanese Military Government on 29 April 1945 to prepare for Indonesian independence.

[23] Indonesian people generally refer to this period as the *Masa Revolusi* (the Revolution Era).

[24] The first military action was on 21 July 1947 and the second military action was on 19 December 1948.

[25] Another important agreement was that the Dutch had to transfer full sovereignty over Indonesia before 30 December 1949.

In his recent article, Surbakti (2002) argues that the unitary system is indeed the most appropriate form for the Indonesian state and elaborates three main reasons underlying his opinion (Bhakti and Gayatri 2002, p.49-52). First, the archipelago characteristics of the territory of the Republic of Indonesia requires a unitary state for maintaining her unity from any attempt to separate one island from the other islands, and for defending herself against external aggression. Second, the unequal distribution of natural and human resources among regions requests a unitary state for their survival and development. Third, there is a perception among Indonesian people that the federal state functions to divide and conquer the Indonesian nation. This perception is a product of the history of the Dutch colonial government in the archipelago, particularly of the 1940s when the federal state was effectively a form of colonialism.

Under the unitary state system and based on the constitutional framework, the government of the Republic of Indonesia is divided into two levels, that is, central and regional government.[26] This is different from a federal system where the government is divided into two state levels, that is, federal and constituent state governments. As Antlov points out, the principle of unitary state grounds sovereignty in the nation as a whole, while the federal principle divides sovereignty between the constituent states and the federation as a whole (Antlov 1999). He argues that a government representing a unitary nation has the right to delegate authority downward to regional/provincial and local institutions, while the principle of a federal system is that each state delegates a certain amount of power upward, to the federal government.

As noted earlier, as a result of the Round Table Conference and especially the diplomatic pressures by the United Nations and the United States, the Dutch transferred full sovereignty over Indonesia on 27 December 1949. However, the victory over the Dutch did not bring peace to Bali. This was due to a conflict between 'Republicans' and 'Loyalists'.[27] As Robinson (1995, p.159) points out, "during the Revolution, Dutch

[26] Regional government in Indonesia usually refers to the sub-national levels of government, including province, district/city, sub-districts, and villages.

[27] The loyalists refer to the old rulers whom they called 'feudal'.

authority had managed to control administrative appointments and to stymie political organisations to such an extent that 'moderate' or 'feudal/loyalists' elements still dominated those posts at the end of 1949". When the sovereignty was surrendered completely by the Dutch, however, the Republicans were able to move into power (Bagus 1991, p.201-2). The island of Bali legally became a province of the Republic of Indonesia in 1958 based on the Law No.64/1958 on the Formation of Bali, Nusa Tenggara Barat, and Nusa Tenggara Timur Provinces, under the authority of a Governor. In 1960, the provincial capital moved from Singaraja (Buleleng) to Denpasar, which was considered preferable because of its proximity to the airport (Picard 1996, p.40).

Like other Indonesian provinces, currently the regional government in Bali follows the Regional Governance Law of 1999. The basic feature of this law is a process of decentralisation, providing autonomous decision making to districts and villages (Antlov 2003, p.197-199). The autonomy is given to district and city governments. In the past,[28] the delivery of services was deconcentrated to regional governments, but decision-making was retained in Jakarta. Antlov (2003) also points out that "with the Law 22/1999 and its sister Law 25/1999 on financial devolution, districts and cities (municipalities) have the leverage to raise their own revenues, deliver services and decide upon local policies without interference from higher authorities".

Moreover, Antlov argues that the Law 22/1999 not only outlines district-level decentralisation, but also replaces the Law No. 5/1979 on Village Governance, which was highly centralised.[29] The Law 22/1999 clearly states that the basis for the new regulations on village government is diversity, participation, genuine autonomy,

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[28] Before the Regional Governance Law of 1999, the legal basis for the Indonesian administration at the sub-national level was the Law No. 5/1974 concerning Basic Principles of Administration in the Region. One of the basic principles of this Law of 1974 (see for example: Rohdewohld, 1995, p.55) is the principle of deconcentration, meaning that some of the matters, which remain the permanent responsibility of the central government, will be carried out by administrative units of the central government representative and/or central apparatus in the autonomous regions. However, policy making in these matters remains at the central level.

[29] According to the logic of Law 5/1979 on Village Governance, the two pillars of the New Order – economic development and national stability – could be achieved only if the central government was in full control of the countryside, supervising village government (Antlov, 2003, p. 195).

democratisation and people empowerment (Elucidation, section 9.1). A village has the right to raise funds, and does not need to consult with or have approval from higher authorities to pass village regulations or budgets. Villages (article 108 of the Law) also may establish their own business entities in order to strengthen and support their local economy. The establishment of the Village Credit Institutions (LPD) of Bali – which have been developed since 1984 - therefore has been reinforced by this Law. In sum, this law could be expected to accelerate the development and to increase the role of the LPDs of Bali.

As set out in Table 4.2, in 2001 the province of Bali consisted of 8 districts[30] and the city of Denpasar, 53 sub-districts and 682 villages. The division of Bali into eight districts reflects the boundaries of the former eight 'kingdoms' (Daroesman 1973). In everyday social and economic life, the 682 administrative villages are less important to the Balinese than the traditional village units, the so-called *desa adat* or custom villages (Daroesman 1973, p.29). At present, there are 1,600 of these custom villages, exerting strong influences over their members, both physically and spiritually. Discussion on the custom village is presented in the next section.

Table 4.2 City/Districts, Sub-districts, and Administrative Villages in Bali Province, 2001

City/Districts	Sub-districts	Administrative Villages
City of Denpasar	3	43
Badung	6	61
Gianyar	7	69
Jembrana	4	51
Tabanan	8	113
Klungkung	4	59
Bangli	4	69
Karangasem	8	71
Buleleng	9	146
Total	53	682

Source: CBS-Bali, Bali in Figures 2001

[30] The term district under the Dutch was known as a regency.

4.4 SOCIO-CULTURAL CHARACTERISTICS

This section discusses the socio-cultural characteristics of the Balinese focusing on the custom village (*desa adat*), *banjar* as corporate groups (social system), and the Balinese traits. This discussion is very useful in assessing the factors affecting the performance of the Village Credit Institutions of Bali since some of these socio-cultural factors, it is argued, have played a major role in the success of government programs such as family planning, small-scale industry training, and loan programs in Bali (Jayasuriya and Nehen 1989, p.13; Warren 1991, p.233) .

As noted earlier, besides the administrative village (*desa dinas*), which is an element of government administration, there are also custom villages (*desa adat*) in Bali. The administrative village (*desa dinas*) or *perbekelan* was first introduced by the Dutch in the early part of the twentieth century as the basic unit of colonial government (Warren 1993, p.22). The existence of administrative village in Bali and all over Indonesia was reinforced by the Government of Republic of Indonesia through the Village Government Law No. 5/1979. This Law sets out to create a uniform local administrative structure across Indonesia, with the stated objective of increasing the effectiveness of village administration and public participation in development policy (Warren 1991, p.238). However, custom villages (*desa adat*) in Bali continued to exist as customary institutions and to function alongside their newly created administrative counterparts.

The custom village is an association of people rather than a geographical or administrative unit. Warren (1993, p.20) describes the custom village as "a corporate community sharing collective descent from the original village founders, who are worshipped as deified ancestors in the classic three village temples the so called *Kahyangan Tiga* (The Three Holy Temples)." Each of the three temples has a special function and location in the village (Geertz and Geertz 1975; Hobart, Ramseyer et al. 1996). The first temple is *Pura Puseh* (Temple of Origin). This is the temple of origin in which the village community worships its purified and deified ancestors. It lies in the

‘godly direction’, that is, towards the mountains and/or east of the village core. Various gods are worshipped in this temple, but the main ones are an anonymous host of deified predecessors of the present inhabitants of the village. In the centre of the village, in the intermediate area between earthly and godly activity, lies *Pura Desa* (Temple of Village or Great Council). This second temple is primarily concerned with the fertility of the farmland in its neighbourhood. The third temple is *Pura Dalem* (Temple of Death) which is usually located next to the cemetery. It lies in the direction of the sea and/or the western part of the village. This temple, in addition to being temple of death, is the temple of chthonic powers where, among other things, the deceased who are not yet fully purified are remembered.

There were two fundamental differences between custom village (*desa adat*) and administrative village (*desa dinas*). The *desa dinas* boundaries are determined along administrative lines and seldom coincide with those of the *desa adat* (custom village). The custom village leader, the so-called *Bandesa Adat,* is elected and custom matters are decided by the community (*banjar*) members in a democratic way in the custom village meeting (*paruman desa*). In contrast, *dinas* (administrative) leaders, the so-called *Perbekel* or *Kepala Desa,* are appointed by, and responsible to, higher government levels such as sub-district and district government level. According to Nordholt (1991), in the Soeharto era, villages maintained the right to choose their *Perbekel* or *Kepala Desa* in Bali, but in practice there were several restrictions. Candidates were screened and sometimes there was pressure from above to eliminate candidates considered to be too independent or anti *Golkar* (state party) (Nordholt 1991).

The status of the custom village as a societal unit based on customary law was reinforced by the Bali Provincial Regulation of 1986 on *the Status, Function, and Role of Custom Village in Bali* (Government of Bali 1986). The custom village, as stated in article 5 of the Regulation, is a unit of societal customary law that is social and religious in nature. The village is the formal repository and guardian of customary law and ritual. Meanwhile, the function and role of custom village, as stated in article 6 of

the Law, is to support the implementation of the development program planned by the government, especially in the religious, cultural, and social area; and to maintain and utilise the wealth of the custom village for the welfare of the people within the village. The ratification of the Provincial Regulation of 1986 reflects the Provincial Government's concern with reinforcing the role of community institutions, grounded in customary law and practice. The consideration of the regulation states that recognition of custom village (*desa adat*) because custom village has grown and developed for centuries and contributed significantly to the liveability of people in Bali.

The custom villages (*desa adat*) are usually subdivided into several *banjar* (hamlets) for densely populated regions (Warren 1993). However, Warren points out that in a large number of communities, especially those found in the mountain areas, *banjar* and custom village represent two associations covering a single bounded population. The *banjar* is the most basic association of people in custom villages (communities) through which religious rites, mutual aid, cultural groups, local development projects and savings and credit activities are organised within close social ties. The members of *banjar* comprise adult men who can prove the completeness of their identity through a female partner – usually the wife, but sometimes sister, mother, or daughter. The focus of religious, social, and economic life of the Balinese is the *banjar,* which effectively[31] implements local custom (*adat*) in the name of the custom village, and organises community life in Bali (Geertz and Geertz 1975; Mabbet 1985; Hobart, Ramseyer et al. 1996). As noted in Chapter 3, the Village Credit Institutions (LPDs) of Bali are rooted in the community and their establishment is grounded in the customary law and practice of its people.[32] The institutions are community financial institutions owned, managed, and used by the members of the custom village. The staff and clients of the LPDs, therefore, have to follow the customary rules (*awig-awig*) of the custom village.

[31] The *banjar* is effective since its decisions involved the equal participation of all families and because it operates through consensus rather than confrontation (Mabbet, 1985, p. 39).

[32] This matter is thoroughly discussed in institutional analysis in Chapter 6.

There have been two important duties of the *banjar* (Mabbet 1985, p.38-40; Hobart, Ramseyer et al. 1996, p.86-88). First, among the most important duties of the *banjar* is the maintenance and restitution of the ritual purity of the custom village (*desa adat*). Each *banjar* has specific tasks and ritual duties to fulfil for the benefit of the village temples. This indicates that the village as a religious-magical authority is ranked above the secular autonomy of the *banjar*. However, *banjar* activities can be very mundane, for example, improving roads through community work or restoring the meeting-house (*bale banjar*). The *banjar* is generally responsible for public institutions and even more for public welfare, which requires not only material support but also assistance in ritual matters.

Another important task of the *banjar* relates to social control and surveillance of the actions and behaviour of the members in relation to the custom (Hobart, Ramseyer et al. 1996). The *banjar* is legally permitted to impose sanctions against members who do not follow the rules (*awig-awig*), and fines may be incurred. Serious offences against the rules are punished by the exclusion of the wrongdoer from the *banjar*. This means that he/she loses his/her share of *banjar* ownership and the plot of land on which his/her family compound is built is withdrawn. He/she also loses the right, in accordance to the custom, to a funeral in the village cemetery and subsequent cremation. He/she becomes an outsider without security of the *banjar* community and must look for a new life far away from their native village. In relation to the LPDs, which are owned by the custom village, these kind social of sanctions could be applied to the staff or clients who violate the rules of the financial institution, such as by corruption or failure to repay their credits properly. In other words, the rules can be expected to have a positive effect on the performance of the LPDs.

Regarding religious affiliation, as is widely known, the predominant religious affiliation of the population of Bali is Hindu. However, the Balinese Hindus follow a highly revised version of Hinduism, a variant which stresses the latter's ritualistic and dramatic aspects over its philosophical and mystical ones (Geertz and Geertz 1975, p.9). Balinese Hinduism contains many elements unique to Bali and omits many that

are important in India. The distinction between gentry and commoner is fundamental to Balinese social structure, but it is not paralleled by an equally sharp cultural distinction. Both gentry and commoner, as well as *Brahmana* priest and layman, hold much the same religious beliefs and participate in much the same rituals.

Geertz and Geertz (1975, p.10) suggest that in general the Balinese religion can be characterised as ‘public’, ‘social’, and ‘civic’. Worship is mostly collective and external, a matter of visible dramatic actions. The number of religious ceremonies in Bali reflects this. The ceremonies are frequent, elaborate, and involve lengthy preparation. Private silent prayer, inward contemplation and personal religious speculation are all unusual, although they do occur. Moreover, Geertz and Geertz (1975) also argue that the most common form of ceremony is the temple festival in which the temple is gaily decorated, there are joyful processions to meet the gods, dances and dramas are performed for their diversionary value, gamelan orchestras play, and, most important, all sorts of foods, each carefully decorated in traditional ways, are ritually offered to the gods. Every detail of these culinary offerings is rigidly prescribed, and the slightest deviation is thought to invite the anger of the gods.

Jensen and Suryani (1992, p. 131-143) conceptualise a number of distinctive traits of the Balinese. However, some of these characteristics are definite while others may be regarded as hypotheses. A descriptive summary about some important traits are as follows. First, the Balinese people posses a strong trait of trust-belief (*percaya*). *Percaya* means both trust and belief and these two attitudes go hand in hand. From birth to about three years, the child is in contact with a kind caretaker virtually all the time. Child abuse, especially of infants or toddlers, is almost unheard of in Bali. From infancy through to maturity, the Balinese people develop and maintain a belief in God along with the other principles of their religion, which not only provides them with a sense of security but also plays a governing role in their behaviour. The Balinese grow up to trust their parents and elders because they have always been taught to respect them. They trust the priests, the custom village leader and believe the laws of the community are in their best interest.

Second, industrious creativity (*glitik*) refers to the self-initiated industrious trait of the Balinese who are perceived to be conscientious and hard working. Most Balinese are industrious but it is difficult to determine what proportion is creative. Creativity is expressed in daily life by innovations and variations in performing ceremonies and the arts, including painting, dance, woodcarving, and music.

Third, a strong commitment to cooperation (*ngayah*) is a striking aspect of many activities and jobs but nowhere more evident than in the clubs (*seka*), the irrigation systems (*subak*), ceremonials of the families (*dadia*), and within the community group (*banjar*). For example, a *dadia* (extended family or clan) ceremony would involve dozens of the related extended families, numbering hundreds in all. The process of preparation is a highly complex one and requires utmost cooperation, with each person doing their part in keeping with tradition and custom. Cooperation is also associated with a sense of devotion or dedication to friends, family, and village. For example, a very good and close friend might offer us assistance with our ceremonial preparations or help us to build a house as an expression of devotion and with no expectation of reward.

Fourth, non-verbal expression of emotion (*semita*) is a trait that often strikes and puzzles foreigners. Verbalisation is not the way that Balinese express emotions. For example it is not their custom to say ‘thank you’ or comment on the dinner being good or delicious. The Balinese show appreciation by subsequent deeds not words, such as expressed by the eye contact or by other facial expressions, evidenced in the Balinese habit of sustaining eye contact and looking directly at a person. The Balinese are said to feel positive emotion ‘in the heart’ but express little outwardly. This has a deeper meaning than words and reflects more a so-called ‘psychic power’.

Fifth, the trait of controlling strong emotion (*nabdabang kayun*) is considered a virtue by the Balinese. This pertains to anger as well as elation. The trait has the same basis in

religion and myth. The religious principle of harmony and balance of the emotions, as well as all things in the universe, are powerful influences.

Finally, it is expected that these socio-cultural characteristics of the Balinese will affect peoples' values, beliefs, perception, and attitudes in respect to economic development in general. The traits of trust-belief, industrious creativity, cooperation, and conformism could be expected to have positive influences on economic development in Bali. The trait of trust-belief is needed in business relation, especially in financial business such as banking or microfinance institution business. Trust is a key factor in those businesses. Industrious creativity is expected to increase quantity, quality, and diversity of products produced by Balinese that in turn will affect the economic and business activities in Bali. The trait of cooperation could be expected to enhance the cooperation and solidarity of the people in developing economic activities in the region. Meanwhile, the trait of conformism could be expected to accelerate the economic development through conformism to institutional and business regulations.

In respect to microfinance institution development, those three traits could be also expected to have positive effects on the development of the Village Credit Institution (LPD) of Bali. The trait of industrious creativity is expected to enable the management staff of LPD to create innovations, such as creating new type of credit or savings, in order to meet the needs of the clients and to expand the LPD. The trait of cooperation is expected to develop a sense of belonging of the staff and the clients of LPD and in turn will affect their compliance to the regulations of LPD. All of these traits eventually are expected to have positive effects on the performance of LPD such as its repayment rate, profitability, outreach, and sustainability.

4.5 ECONOMIC SITUATION

Economic growth and sectoral changes

In line with the national economy, before the Indonesian economic crisis started in 1997, the regional economy of Bali grew rapidly and moved away from agriculture towards services, manufacturing and transport industries (Bendesa and Sukarsa 1980; Jayasuriya and Nehen 1989). Bendesa and Sukarsa (1980) reveal that the highest growth rate in the 1970s was in construction, but services, manufacturing and transport also showed strong growth. During the 1980s and the beginning of the 1990s, according to Statistics of Bali Province, the annual growth in Gross Regional Domestic Product (GRDP) varied between 8 percent and 9 percent per annum. It was about 2 percent above the national average. At the end of the 1990s, however, the growth slowed and a negative growth of 4.04 percent was recorded in 1998. This rate of decrease, however, was considerably less than the national average of decline of 13.13 percent per annum. The economy of Bali started to recover and achieved a positive growth rate again in the early 2000s. The data from Statistics of Bali Province reports that in 2001 the growth rate was 3.4 percent, which was slightly higher than the national average of 3.3 percent.

Despite the substantial growth, Bali's economic performance was not outstanding in a comparative context. While its GRDP per capita was marginally above the national average between 1995 and 2000 (CBS of Indonesia 2001), it was lower than that of some provinces outside Java such as Aceh, East Kalimantan, Riau, and Papua. However, these four provinces are the main producers of natural resource products such as gas, copper, and oil, and they have smaller populations and a lower population density. Given its population density, lack of natural resources (mining industries) and proximity to Java, Bali is more appropriately compared with the provinces of Java. In this comparison, Bali's economic performance was better in terms of GRDP per capita during that period (Jayasuriya and Nehen 1989, p.333).

At the district level, the contribution of each district to Bali's GRDP has been quite uneven. In terms of per capita GRDP, Badung has been the leading district in the province since 1970s (Jayasuriya and Nehen 1989). Recent data shown in Table 4.3

also reveals that Badung still occupied this position, with the share of 24 percent of the province's GRDP and a per capita GRDP of Rp8.9 million in 1999, followed by the city of Denpasar and by Buleleng and Gianyar districts. At the other end of the spectrum, Karangasem has been the district with the lowest per capita GRDP since the 1970s (Jayasuriya and Nehen 1989). Substantial differences among other districts are also evident in Table 4.3. Per capita GRDP in 1999 for the city of Denpasar, Badung, and Gianyar districts, for example, are almost double or triple of Karangasem's per capita GRDP. In addition, the per capita GRDP of these three regions are also higher than the provincial per capita GRDP, indicating that these are the more prosperous regions in Bali.

Table 4.3 Distribution of Gross Regional Domestic Product of Bali Province at Constant 1993 Price by City/district, 1996 and 1999

City/District	Percentage Share of Bali's GRDP		Per capita GRDP (thousand Rp)	
	1996	1999	1996	1999
City of Denpasar	19.7	19.7	3,926	5,910
Badung	24.2	24.1	6,585	8,936
Gianyar	11.3	11.6	2,906	4,985
Jembrana	6.8	6.8	2,663	4,306
Tabanan	9.8	9.7	2,261	3,660
Klungkung	4.1	4.9	2,768	4,477
Bangli	4.8	3.6	2,297	3,589
Karangasem	7.1	7.2	1,706	2,830
Buleleng	12.2	12.4	1,830	3,105
Total	100.0	100.0	2,959	4,790

Source : 1. CBS- Indonesia, *Gross Regional Domestic Product of Provinces in Indonesia by Industrial Origin*, 1996-1999.
2. CBS-Bali, *Bali in Figures*, 2001

As previously stated, Bali's economy has been showing a tendency of transforming from agricultural based economy to a light industrial and services based economy. Bendesa and Sukarsa (1980) report that there has been a substantial growth in the service industry and trade (which includes hotels and restaurants) and a corresponding drop in agriculture since the 1970s. This tendency is indicated by the share of non-agricultural sectors - such as the manufacturing, mining and quarrying, construction, banking and financial services – in GRDP. Recent data from CBS of Bali (1991 and

2001) show that this share increased from 55 percent in 1980 to 69 percent in 1991 and 80 percent in 2001. This confirms the theory of structural change in developing economies (Kuznets 1966; Chenery and Syrquin 1975). However, the structural change in Bali is mainly from agriculture to services rather than manufacturing.

Employment condition

The employment condition of Bali province is relatively favourable. According to the data from *Bali in Figures 2001* (CBS of Bali 2001) and *Statistical Yearbook of Indonesia* (CBS of Indonesia 2001), in 2001 its labour force participation rate[33] and open unemployment rate were 63.4 percent and 2.8 percent respectively. Even though its labour participation rate was slightly lower than the national average (68 percent), its open unemployment rate is much better than the national average (8.2 percent). Most of the employment (73.3 percent) was in the three main economic sectors, the agricultural, manufacturing, and trade, hotel and restaurants sectors.

Like its economic structure, Bali's employment structure is also changing. The role of the agricultural sector in employment has tended to decline, even though this sector is still a dominant sector in employment. Table 4.4 shows that in 1997, 40 percent of the total employed worked in the agricultural sector. This figure decreased significantly to 34.7 percent in 2001. Compared to the national average (44 percent of employment in agricultural) in 2001, this figure is much lower. Meanwhile, the declining trend in agricultural employment corresponded with a rising trend of employment in manufacturing and tourism related sectors, such as trade, hotels and restaurants, transportation and communications, and financial services. In 1997, manufacturing absorbed 13 percent and tourism-related sectors 24.8 percent of total employment. In 2001, these figure increased to 15 percent and 29.6 percent respectively. This indicates that the employment structure in Bali tends to be more 'service and industrial'in

[33] According to the Central Board of Statistics (CBS) of Indonesia (2002), the labour force is defined as people aged between 15–65 years old and over who are working, or have a job but are temporarily absent from work, and those who were looking for work. Labour force participation rate refers to the ratio between labour force (those 15 to 64 years of age) and the total number of people in the same group of age.

structure than in Indonesia as a whole. This trend has been evident since the 1970s (Bendesa and Sukarsa 1980).

Table 4.4 Employment by Economic Sectors in Bali Province, 1997 and 2001

Sectors	1997		2001	
	000	%	000	%
1. Agriculture	661.2	40	550	34.7
2. Mining & quarrying	15.6	0.9	7.4	0.5
3. Manufacturing	223.5	13	239.3	15
4. Electricity, gas & water supply	6.8	0.4	2.8	0.2
5. Constructions	114.9	7	124.5	8
6. Trade, hotel & restaurants	330.2	20	374.3	23.6
7. Transportation & communications	62.3	3.8	68.3	4
8. Finance, rent & business services	22.5	1	30.9	2
9. Other services	208	13.9	186.3	12
Total employment	**1,645**	**100.00**	**1,583.8**	**100.00**

Source: CBS-Bali, Bali in Figures, 1999 & 2001

Tourism-based economy

The Bali economy nowadays is considered a tourism-based economy. Long before tourism made a significant contribution to the regional economy, Bali was known to the rest of the world as the Island of the Gods, the Island of Temples, or the Island of Artists (Covarrubias 1986; Vickers 1989; Vickers 1994; Hofer 1996; Picard 1996). From the beginning, it was those outside Bali who promoted Bali as a tourist paradise. Bendesa and Sukarsa (1980, p.33) point out that since the 1960s tourism has begun to be expected - by Indonesians generally and the Balinese particularly - to play a major role in Bali's economy. In the early 1970s, Bali experienced a phenomenal growth in tourism. Between 1969 and 1973, the number of tourists travelling to Bali more than doubled, between 1973 and 1976 it doubled again from 53,083 to 115,220 (Bendesa and Sukarsa 1980, p.34). Recent data reveal that Bali attracted around 1.3 million visitors each year between 1997-2001 from around the world (CBS of Bali 2001).

It is evident that Bali's economy has been strongly influenced by rapid growth in the tourism sector and its related industries[34] such as trade, hotels and restaurants, finance

[34] These sectors are considered as tourism related sectors since these sectors have strong ties to the tourism industry in terms of providing the needs of tourists for services of meals, rooms, money, transport, and communication.

and business services, and manufacturing (including handicrafts) industries. Before the Indonesian economic crisis, in 1996 the GRDP of these sectors grew 10.13 percent, 9.49 percent, and 10.19 percent per annum respectively (CBS of Bali 2001). During the crisis and recovery period from 1998 to 2001, these sectors experienced positive average growth rate of 0.61 percent, 1 percent, and 1.38 percent per annum. These figures imply that the three sectors are the leading sectors that have the potential to accelerate and strengthen the Balinese economy in the future.

In respect to contribution to GRDP, in 2001 the contribution of those tourism-related sectors such as trade, hotels and restaurants, finance and business services, and transportation and communication made up 50.8 percent of the GRDP as shown in Table 4.4. A large part of the sectors is concentrated in the southern districts of Bali such as the city of Denpasar, Badung, and Gianyar districts. Most classified hotels (89 percent) and restaurants with more than 20 beds (86 percent) are located in these three regions (CBS of Bali 1999d). Table 4.3 reveals that in the period 1996-1999 the contribution of the southern districts to the GRDP of Bali was about 55 percent and the rest of it was contributed by other six districts. The figures imply that, as noted earlier, at the district level, economic development has been quite uneven in Bali. This phenomenon has emerged since the early stage of tourism development in Bali (Daroesman 1973). To understand this phenomenon, it will be useful to trace back the history of tourism development in Bali.

Bali province as the main tourist destination in Indonesia has a long history. According to some scholars and writers (Hobart, Ramseyer et al. 1996; Hofer 1996; Picard 1996), tourism began in Bali in the 1920s during the Dutch colonial period. Even though it is very hard to know how many tourists came to Bali during that time, it was estimated that in the 1920s Bali was visited by a few hundred tourists a year and in the 1930s by a few thousand (Picard 1996, p.25). They used to stay either on a cruise ship, anchored in Padang Bay, aboard the weekly KPM steamship that called at the port of Buleleng, or in resthouses for Dutch officials. Picard (1996) also states that they came for a few days

of romantic escapism. An assortment of artists and writers, aesthetes and expatriates even came to stay. Picard (1996) mentions that one of the first and most famous was the German musician and painter, Walter Spies. He moved to Bali in 1926 after spending a few years as a bandmaster at the court of the Sultan of Yogyakarta. In addition to Spies, well-known visitors included the Dutch painter Rudolf Bonnet and the Belgian painter Le Mayeur de Perpres.

In 1968, after Soeharto became President of the Republic of Indonesia, Bali became the blueprint for tourism development Indonesia (Daroesman 1973; Bendesa and Sukarsa 1980). The first Indonesian Five-Year Development Plan (1969-1974) emphasised the importance of international tourism as a factor of Indonesian economic development. In March 1969, therefore, a delegation from the World Bank travelled to Indonesia at the government's request and recommended drawing up a Master Plan for the development of tourism in Bali (Daroesman 1973, p.50; Bendesa and Sukarsa 1980, p.34-37; Picard 1996, p.46-47). After inviting tenders from various international groups, the government engaged a French firm, SCETO, to work on the Master Plan. The analysis of the Master Plan was primarily focused on the accommodation needs of seaside tourism, as well as considerations to protect Balinese society and its culture from over-exposure to foreign visitors. These considerations led the consultants to propose that tourism should be concentrated in one place that met the following conditions: removed from the local population; by the sea; near the airport; and not too far from the most attractive regions in the southern part of the island. This resulted in the tourism related sectors being concentrated in the southern part of Bali province, as mentioned before.

The secondary needs of tourists were 'discovery' and cultural tourism. These would be met by the creation of a network of routes giving access to the principal sites of the island. The network would consist of tourism centres run by Balinese people. Since these centres were considered as a means of integrating tourism with Balinese society, they would involve local communities in their activities. Finally, dance performances were organised especially for tourists, freely transposed from the traditional forms and adapted for a diverse foreign audience. This was intended to safeguard religious

ceremonies and the various performances that adorn them, as well as to save tourists the discomfort and long waits characteristic of these performances.

The Master Plan was published in April 1971. It was adopted the following year by Presidential Decree and ratified by the Bali Provincial Assembly in December 1973. Since 1973, therefore, tourism has officially become the second economic priority for Bali after agriculture. In short, it could be inferred that the uneven economic development in Bali is mainly caused by the emphasis of tourism development in southern part of Bali based on the Plan (Daroesman 1973, p.55). According to the Plan, the development of infrastructure was mainly concentrated in the southern districts, in turn encouraging the faster pace of economic development in these districts compared with the rest of the province.

In addition, uneven development was worsened by the development priorities set by the Provincial Government of Bali. Based on the Development Plan of Bali Province 1989, the priorities were centred on the natural resources endowment - such as conditions of land, amenity, and tourism objects - owned by each region. In the development plan the western, eastern and northern regions[35] are mainly considered as growth areas for agriculture and agro-industries, whereas the development priorities for the southern districts are handicraft industries, cottage industries, tourism, trade and transport services (Government of Bali 1989).

The uneven development between the relative prosperity of the south-central core and the poorer, drier areas of the west, north and east was already evident before the Tourism Master Plan (Daroesman 1973, p.55). In December 1972, to reduce the uneven development problem the Governor of Bali requested Badung district – which receives the largest share of income from tourism – to contribute 30 percent of its hotel tax receipts to be divided among other districts (Daroesman 1973, p.55). However, this contribution has done little to mitigate inequalities in tax revenues among districts.

[35] As mentioned earlier, these three regions are poorer and drier compared to the southern regions.

Therefore, the Bali provincial government should now reconsider the development priorities in order to reduce the uneven regional economic development.

A positive contribution of tourism development to Bali's economy is particularly its effect on some manufacturing activities. It is argued that the stimulus for the expansion of the handicraft industries came from the demand generated by the tourism sector (Bendesa and Sukarsa 1980; Jayasuriya and Nehen 1989). The unique characteristics of Bali and its reputation as a centre of arts and crafts have increased the tourists' demand for handicrafts products. These products are made by craftsmen and sold not only through art-shops as souvenirs to tourists but they also take orders from overseas dealers. This generated a major expansion of the handicrafts industries producing Balinese products. The handicraft industry in Bali has developed considerably since the 1920s when the first influx of visitors stimulated its expansion (Jayasuriya and Nehen 1989; Hofer 1996). Even though it was interrupted by the Second World War, in the post-independence period it resumed its growth. Responding to increasing tourist demand, wooden handicrafts (mainly woodcarving), gold and silverwork are important sources of income and employment, centred around the tourist sites.

In sum, Bali has performed well over the last three decades in terms of economic growth and employment conditions. Its high economic growth, which is mainly affected by the growth of the tourism sector and its related sectors (such as trade, hotel and restaurants, transportation and telecommunications, other services; and handicrafts industries) has raised incomes and employment opportunities in Bali.

4.6 SUMMARY

Bali has unique characteristics. Its population is strongly influenced by the Hindu religion and custom, which is reflected by the interrelating role of the religion, the custom village, and *banjar* (hamlet) in their social and economic life. The *banjar* has the power to conduct social control and surveillance of the actions and behaviour of its members in relation to the custom. The *banjar* is also legally permitted to interfere,

using sanctions against its members who do not follow the custom village rules (*awig-awig*).

Bali has experienced a relatively stable and high economic growth since the early 1970s. The major contribution to this growth has come from tourism related sectors, particularly the trade, hotels and restaurants sector. Manufacturing and other services sectors - such as financial, transportation and telecommunication - have also made a significant contribution to economic growth. The rapid expansion of handicrafts industries in Bali could be attributed to the growth of those tourism related sectors. The agricultural sector, in terms of labour force and regional income (GRDP), still has an important role in the economy of Bali.

In relation to this study, the socio-cultural characteristics of Bali and its economic situation seem to constitute a good environment for enhancing the development of the Village Credit Institutions (LPDs) of Bali. A stable and growing macro economic situation accompanied by strong local institutions - indicated by the important role of the custom village (*desa adat*), custom village regulations (*awig-awig*), and the Balinese traits - have fostered the growth of LPD in Bali. In addition to this, the legislation made by the government – both in the national level and in the provincial level – also provides a favourable regulations environment. The government and banking-related regulations allow the regional government at all levels (provincial, district, sub-district, and village level) to set up and develop their own business entities such as the LPDs.

Chapter Five
Research Methodology

5.1 INTRODUCTION

One of the core arguments in the thesis is that a microfinance institution is generally characterised by a collage of dynamic, innovative, and flexible arrangements that are tailored to the local economic and social environment (Adams and Fitchett 1992). In other words, microfinance institutions are complex phenomena that have economic and socio-cultural dimensions (Meyer and Rowan 1977; DiMaggio and Powell 1983; Baum and Oliver 1991; Rhyne and Otero 1992; Carrol 1993; Chaves and Gonzales-Vega 1996; Oliver 1997). In order to capture such a complex phenomena and to assess the performance and sustainability of microfinance institutions and the affecting factors, this study seeks to triangulate methods and tools of analysis. Specifically, this study uses an embedded case study design, which involves more than one unit of analysis (Yin 2003, p.42). Yin points out that this approach occurs when within a single case, attention is also given to a subunit or subunits of the case, as is in this study. He also argues that this approach can often add significant opportunities for extensive analysis, enhancing the insights into the single case. This approach is an appropriate one in assessing the complex phenomenon of microfinance institutions and in assessing the influence of the socio-cultural environment on microfinance's performance and sustainability. This approach distinguishes this study from previous studies on microfinance institutions in Indonesia, for example, the studies by Chaves & Gonzales-Vega (1996), Mosley (1996a), Yaron *et al* (1998), and Charitonenko *et al* (1998). The previous studies used a different approach – the so-called holistic case study design - in examining the performance of microfinance institutions in Indonesia. A holistic case study design is a case study that examined only the global nature of a case. One

potential problem in using this approach is that it allows a researcher to avoid examining any specific phenomenon in operational detail (Yin 2003).

This chapter which describes the methodology for assessing the performance and sustainability of the Village Credit Institutions of Bali and the affecting factors, consists of three parts. The first part describes research paradigms and the use of triangulation in this study. The underlying reasons why a case study strategy is adopted in conducting this research is elaborated in the second part. In the last part of this chapter, the specific research procedures are described and justified. Specifically, it describes the selection of the case study, the fieldwork conducted, including data collection (through collection of documentary information, archival records, and interview), methods and tools of analysis that use the triangulation technique by using quantitative and qualitative methods of data collection and analysis.

5.2 RESEARCH PARADIGMS AND TRIANGULATION

The relationship between data and theory is an issue that has been hotly debated by philosophers for many centuries (Easterby-Smith, Thorpe et al. 1991, p.21). It is argued that failure to think through philosophical issues such as this, while not necessary fatal, can seriously affect the quality of research. That is why this methodology begins with a discussion of the main philosophical or paradigm choice underlying this study.

The term ‘paradigm’ refers to the progress of scientific practice based on people’s philosophies and assumptions about the world and the nature of knowledge (Hussey and Hussey 1997) According to Kuhn, paradigms are ‘universally recognized scientific achievements that for a time provide model problems and solutions to a community of practitioners’ (Kuhn 1970 p.viii). Following Morgan (1979), Hussey & Hussey (1997, p.47) suggest that the term paradigm can be used at three different levels: at the philosophical level, where it is used to reflect basic beliefs about the world; at the social level, where its is used to provide guidelines about how the researcher should

conduct his or her endeavours; and at technical level, where it is used to specify the methods and techniques which ideally should be adopted when conducting research.

Easterby-Smith *et al* (1991) point out that there are three important reasons why an understanding of this philosophical or paradigm issue is very useful in conducting research:

> First, it (understanding of paradigm) can help to clarify research designs, and by 'research design' we mean more than simply the methods by which data is collected and analysed. It is the overall configuration of a piece of research; what kind of evidence is gathered from where, and how such evidence is interpreted in order to provide good answers to the basic research question. Second, a knowledge of philosophy can help the researcher to recognise which designs will work and which will not. It should enable the researcher to avoid going up too many blind alleys and indicate the limitations of particular approaches. Third, a knowledge of philosophy can help the researcher identify, and even create, designs that may be outside his or her past experience. It may also help the researcher to adapt research designs according to the constraints of different subject or knowledge structures (Easterby-Smith, Thorpe et al. 1991, p.21).

The quote above clearly shows that selecting a research strategy has to be based on a research paradigm or philosophy adopted in the research (Easterby-Smith, Thorpe et al. 1991, p.21 ; Hussey and Hussey 1997, p.54; Remenyi, Williams et al. 1998, p. 37). The quote also shows that the three levels of paradigm are connected. Nevertheless, while acknowledging this connection, I am here concerned with the technical level, that is, with how this research ideally should be conducted and what methods and techniques should be adopted.

In the relevant literature, there have been two main research paradigms or philosophies in the social sciences. These are the so-called positivist and phenomenological approaches.[36] The positivistic paradigm in the social sciences is historically based on the approach used in the natural sciences, such as biology, botany, and physics. The French philosopher, Auguste Comte (1798-1857) was an early and influential proponent of this paradigm. Comte outlined this approach in his *Course of Positive*

[36] Creswell (1994, p.4) presents other terms for the two paradigms which are the quantitative and qualitative paradigm for the positivistic and phenomenology approach respectively.

Philosophy in six volumes between 1830 and 1842 (Easterby-Smith, Thorpe et al. 1991; Remenyi, Williams et al. 1998).

Remenyi *et al* (1998) point out that the positivistic paradigm sees the researcher as an objective analyst and interpreter of a tangible social reality. Underlying this paradigm is the assumption that the researcher is independent and neither affects and nor is affected by the subject of the research. It is assumed that there are independent causes that lead to the observed effects, that evidence is critical, that parsimony is important and that it should be possible to model, especially in the mathematical sense, the observed phenomena. Hence, this paradigm emphasises quantifiable observations that lend themselves to statistical analysis (Ethridge 1995, p.61; Hussey and Hussey 1997, p.52; Remenyi, Williams et al. 1998, p.33).

Remenyi *et al* (1998) also point out that one of the principles of positivism is that it takes a reductionist approach to exploring the relationships among the variables being studied. This reductionist approach should by its very nature lead to simplifications of the real world environment in which the variables naturally or usually exist. Remenyi *et al* (1998) argue that this simplification means that in the results of positivist research some of the complicating factors, and possibly the most interesting factors, have been stripped out.

Hussey and Hussey (1997) also emphasise that the positivistic approach seeks the facts or causes of social phenomena, with little regard to the subjective state of the individual. Therefore, logical reasoning is applied to the research so that precision, objectivity and rigour replace hunches, experience and intuition as the means of investigating research problems. Further, positivists argue that the study of human behaviour should be conducted in the same way as studies conducted in the natural sciences.[37] According to positivists, laws provide the basis of explanation, permit the anticipation of phenomena, predict their occurrence and therefore allow them to be

[37] Aiken (1956) argues that this view originated as a reaction to metaphysical speculation (Easterby-Smith *et al*, 1991, p.23).

controlled. Explanation consists of establishing causal relationship between the variables by establishing causal laws and linking them to a deductive or integrated theory. Thus, social and natural worlds are both regarded as being bound by certain fixed laws in a sequence of cause and effect (Hussey and Hussey 1997, p.52). In sum, the key idea of positivism is that the social world exist externally, and that its properties should be measured through objective methods, rather than being inferred subjectively through sensation, reflection or intuition (Easterby-Smith, Thorpe et al. 1991, p.22).

Positivism has developed into a distinctive paradigm over the last one and a half centuries. However, there have been a lot of criticisms on the positivistic approach regarding the application of this approach to the social sciences. Hussey and Hussey (1997, p.53) summarise the main criticisms of the positivistic paradigm:

1. It is impossible to treat people as being separate from their social contexts and they cannot be understood without examining the perceptions of their own activities.
2. A highly structured research design imposes certain constraints on the results and may ignore more relevant and interesting findings.
3. Researchers are not objective, but part of what they observe. They bring their own interests and values to the research.
4. Capturing complex phenomena in a single measure is, at best, misleading.

Hence, the positivistic approach is not regarded as the only approach that will lead to interesting or profound insights into complex problems, especially in the field of business and management studies (Saunders, Lewis et al. 2000, p.86). Saunders *et al* (2000) argue that the social world of business and management is far too complex to lend itself to theorising by definite 'laws' in the same way as the physical sciences. Moreover, business situations are unique. They are a function of a particular set of circumstances and individuals, for instance, in the world of organisational behaviour.

During the last fifty years in particular, a new paradigm has arisen, mainly as reaction to the application of positivism to the social sciences as stated above. Following Husserl (1946), Easterby-Smith *et al* (1991, p.24) point out that this new paradigm – the so-called phenomenological paradigm[38] - stems from the view that the world and

[38] Phenomenological is derived from Greek verb 'phenomenon' which means to appear or show. Allen (1990) defines a phenomenon as 'a fact or occurrence that appears or is perceived, especially one of which the cause is

'reality' are not objective and exterior, but they are socially constructed and given meaning by people. The phenomenological school of thought started with the work of Franz Brentano (1838-1917) and was further developed by Edmund Husserl (1859-1938), who set out the basic methods of phenomenology in his work *Logical Investigations* (Remenyi, Williams et al. 1998, p. 34).

This paradigm is concerned with understanding human behaviour from the participant's own frame of reference. Unlike the positivist, the phenomenologist does not consider the world to consist of an objective reality but instead focus on the primacy of subjective consciousness. Each situation is seen as unique, and its meaning is a function of the circumstances and the individuals involved. To this paradigm the researcher is not independent of what is being researched but is an intrinsic part of it (Easterby-Smith, Thorpe et al. 1991; Remenyi, Williams et al. 1998).

Remenyi *et al* (1998) point out that this approach to research is not reductionist but holistic. This approach enables much more complicated situations to be examined. A study using this paradigm involves as many variables as possible and pulls in the context of the study. The researcher and the characteristics of the setting thus form part of a phenomenological study, while they would be removed from a positivist study. At the end of the research study, the phenomenological researcher has produced a still photograph of the variables being studied. However, this photograph is more sophisticated than the one obtained by a positivist study because it looks beyond the details of the situation to understand the reality or perhaps a reality working behind them (Easterby-Smith, Thorpe et al. 1991; Remenyi, Williams et al. 1998, p.35; Saunders, Lewis et al. 2000).

Sometimes the two approaches are distinguished by arguing that the positivist's findings can be modelled, while the phenomenologist's findings cannot (Remenyi, Williams et al. 1998, p.36). This view is a misunderstanding of the concept of a model.

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under question.' Phenomenology is the science of phenomena. Therefore, the phenomenological paradigm is concerned with understanding human behaviour from the participant's own frame reference (see Hussey & Hussey, 1997, p. 52).

The positivist model is more likely to be expressed mathematically than the phenomenologist's. For the phenomenologist, a model does not necessarily need to be expressible through a mathematical formula. A verbal, diagrammatic, or descriptive model could be acceptable. However, both are models and can be used to explore different situations. Remenyi *et al* (1998) also argue that another difference between positivist and phenomenological research is the degree of caution with which the results will be used, which needs to explained and thus accommodated.

Those two paradigms discussed above are the pure versions of each paradigm. Easterby-Smith *et al* (1991) argue that even though the basic beliefs may not be compatible, when one comes down to the actual research methods and technical used by researchers the differences are by no means so clear cut and distinct. Increasingly, there is a move amongst researchers in business and management fields to develop methods and approaches which provide a middle ground, or a bridging between the two paradigms (Easterby-Smith, Thorpe et al. 1991, p.26; Saunders, Lewis et al. 2000, p.86). Further, Saunders *et al* (2000) argue that, in practice, research rarely falls neatly into the positivist or phenomenological approach. Business and management research is often a mixture between the two. These approaches do not exist in isolation and therefore can be 'mixed and matched'. Not only can they, but it is often beneficial to do so. It is quite usual for a single study to combine quantitative (positivist) and qualitative (phenomenological) methods and to use primary and secondary data (Saunders, Lewis et al. 2000, p.98).

Saunders *et al* (2000, p.98-99) suggest two major advantages for employing multi-methods in the same study. First, different methods can be used for different purposes in a study. The second advantage is that it enables triangulation to take place. Then, seeing positivism and phenomenology as related concepts rather than as two extreme and separate approaches is useful. This view, together with the understanding that empirical and theoretical research should also not be seen as operating separately, but rather as being in a dialectical relationship, helps in seeing research methods as

providing a set of tools or directions which the researcher may draw on as and when appropriate (Remenyi, Williams et al. 1998, p.37; Saunders, Lewis et al. 2000).

Remenyi *et al* (1998) also argue that approaching these difficult issues of empiricism, theoretical research, positivism and phenomenology should encourage the researcher to draw on whichever is appropriate in a particular situation, to triangulate the findings and theories and in this way to validate findings within one research study. The use of different methods in one research study would lead to greater validity and reliability than a single methodological approach (Denzin 1978, p.292). Further, Denzin emphasises that this technique can overcome the potential bias and sterility of a single-method approach.

Triangulation refers to the use of different research approaches, methods and techniques to study the same phenomenon in a single study (Denzin 1978).[39] Miles and Huberman (1994, p.267) point out that when a researcher self-consciously sets out to collect and double check findings, using multiple sources and modes of evidence, the verification process will largely be built into data collection. As a result, triangulation is a way to get the finding in the first place – by seeing or hearing multiple instances of it from different sources by using different methods and by squaring the finding with others it needs to be squared with. Triangulation can also capture a more complex, holistic, and contextual portrayal of the unit(s) under study (Jick 1979, p.603). Similarly, Eisenhardt (1995, p.73) describes triangulation of methods as an aid to data capture and to stronger substantiation of constructs and hypotheses.

Denzin (1978) suggests four types of triangulation. First, data triangulation, when data is collected at different times or from different sources in the study of a phenomenon. Second, investigator triangulation, where different researchers independently collect data on the same phenomenon and compare the results. Third, methodological triangulation, when both quantitative and qualitative methods of data collection are

[39] *Triangulation* is a term borrowed from navigation and surveying where a minimum of three reference points are taken to check an object's location (Easterby-Smith et al, 1991, p.133).

used. Fourth, triangulation of theories is that when a theory is taken from one discipline (for example, economics) and used to explain a phenomenon in another discipline (for example, finance).

Since this study is conducted by one researcher only and not intended to use a theory of one discipline to explain a phenomenon in another discipline, this study only employs the data and methodological triangulation. The data of this study will be collected from different sources with different collection techniques includes collecting documentation (archival record), interviews with stakeholders of the LPD, and direct observation by making field visit to the the LPD site. The methodological triangulation will be used by using quantitative (statistics and econometrics) and qualitative (descriptive and SWOT analysis) methods of analysis.

5.3 A CASE STUDY STRATEGY

As discussed in the previous section, the types of research methodology[40] should reflect the assumptions of the research paradigm. Some methodologies can be used under either a positivistic or a phenomenological paradigm, depending on the assumptions of the research paradigm of the researcher. Each methodology can move some way along the continuum according to the individual researcher's assumptions, since those two paradigms are near the extremities of the continuum. One of the research strategies lying along the continuum is a case study strategy. Remenyi *et al* (1998, p.51) argue that because of its flexible nature, a case study strategy may be an almost entirely positivistic or almost entirely phenomenological study, or anything between these two extremes.

There has been an extensive discussion in the literature of case study strategies. Eisenhardt (1989) refers to the case study as a research study which focuses on

[40] Some writers use the words methodology and methods interchangeably. In this study, the words are distinguished: methodology refers to the overall approach to the research process, from theoretical underpinning to the collection and analysis of the data; methods, on the other hand, refer only to the various means by which data can be collected and/or analysed (see Hussey and Hussey 1997, p. 44).

understanding the dynamics present within single settings (Eisenhardt 1989, p.534). Stake (2000) explains that a case study is a study of a bounded system, emphasizing the unity and wholeness of that system, but confining attention to those aspects that are relevant to the research problem at the time. Creswell (1994) provides a similar definition with five components. A case study is a single, bounded entity, studied in detail, with a variety of methods, over an extended period. In case studies, 'the researcher explores a single entity or phenomenon ("the case") bounded by time and activity (a program, event, process, institution, or social group) and collects detailed information by using a variety of data collection procedures during a sustained period of time' (Creswell 1994, p.12). Yin (2003, p.13-14), in his book *Case Study Research: Design and Methods*, formulates the technical definition of case study as follows.

> A case study from a research strategy point of view may be defined as an empirical inquiry that investigates a contemporary phenomenon within its real-life context, especially when the boundaries between phenomenon and context are not clearly evident. A case study copes with the technically distinctive situation in which there will be many more variables of interest than data points, relies on multiple sources of evidence, with data needing to converge in triangulating fashion, and benefits from the prior development of theoretical propositions to guide data collection and analysis.

As mentioned earlier, this study attempts to investigate a complex phenomenon of microfinance institution and its contextual conditions. More specifically, this study attempts to assess the influences of informal (socio-cultural environment) and formal institutions and their interrelationships on the practical operational arrangement of microfinance institution and their influences on the financial performance and outreach of the institution. However, the phenomenon and the context are not distinguishable in real life situations. Therefore, the use of a case study strategy and triangulation of methods and data analysis is suitable to this study in order to answer the objectives of this study.

The characteristics of the case study strategy then can be outlined as follows (Punch 1998, p.153; Yin 2003). First, the case is a bounded system. It has boundaries, even though the boundaries between the case and the context, as Yin points out (1994 and 2003), are not necessary clearly evident since the research aims not only to explore

certain phenomena, but also to understand them within a particular context. However, the researcher needs to identify and describe the boundaries of the case as clearly as possible. Second, the case is a case of something. This may seem obvious, but it needs stressing, to give focus to the research, and to make the logic and strategy of the research clear. Identifying the case is important in determining the unit of analysis and in the analysis of data. Third, there is an explicit attempt to preserve the wholeness, unity and integrity of the case. This is frequently referred to as a holistic approach. Fourth, multiple sources of data, multiple data collection methods and analysis are likely to be used in this research strategy.

Remenyi *et al* (1998, p.164) also outline two distinct features of the case study strategy: firstly, the case study can be used in establishing valid and reliable evidence which can be analysed from either a positivistic or a phenomenological perspective and subsequently synthesised in such a way to produce a theoretical conjecture or even to be used as evidence to support or contradict an already established theory. Secondly, the case study can be used as a vehicle for creating a story or narrative description of the situation being studied, in such a way that the resulting narrative represents a research finding in its own right and thus can be said to have added something of value to the body of knowledge.

Concerning its types, Stake (2000, p.437) suggests three types of case study. First, an intrinsic case study is a case study when the study is undertaken because the researcher wants a better understanding of a particular case. It is not undertaken primarily because the case represents other cases or because it illustrates a particular trait or problem. Rather, it is because of its particularity and ordinariness that the case is studied. The researcher temporarily subordinates other curiosities so that the case may reveal its story. The researcher's purpose is not to understand or test abstract theory or to develop new theoretical explanations; instead, the intention is to understand intrinsic aspects of the object of the study, such as a particular microfinance institution, more deeply. The first type of Stake's case study seems to be related to the second feature of case study suggested by Remenyi *et al* (1998) that is case study as narrative.

Second, an instrumental case study is a case study where a particular case is examined to give insight into an issue, or to refine theory. In this situation, the particularities of the case are of secondary importance. It will serve only a supportive role, a background against which the actual research interests will play out. Instrumental case studies are often investigated in depth, an all of its aspects and activities are detailed, but not simply to elaborate the case *per se*. Instead, the intention is to assist the researcher to better understand some external theoretical question or problem. Instrumental case studies may or may not be viewed as typical of other cases. However, the choice of particular case for study is made because the researcher believes that his or her understanding about some other research interest will be advanced. Third, collective case study, when the instrumental case study is extended to cover several cases, to learn more about the phenomenon, population or general condition. The former two of these are single case studies, where the focus is within the case. The third involves multiple cases, where the focus is both within and across cases. It is also called the multiple case study or the comparative case study.

Scapens (1990, p.265) suggests the five types of case study, which are descriptive, illustrative, experimental, exploratory, and explanatory case studies.[41] The descriptive and explanatory case studies of Scapens are similar to the intrinsic and instrumental case studies of Stake, respectively. The descriptive case study refers a case study where the objective is restricted to describing current practice, while the explanatory case study refers to a case study where existing theory is used to understand and explain what is happening (Scapens 1990, p.265). These last two types of case studies are most relevant to this study. The underlying reasons are discussed below.

First, this study attempts, as noted earlier, to capture a complex phenomenon of microfinance institution in a more holistic and contextual way. In addition to the

[41] Scapens however emphasizes that the distinctions between these different types of case studies are not clear-cut. For example, the subject matter of illustrative case studies should be regarded as existing procedures and the basis of descriptive case studies; and an exploratory study may be concerned with generating initial ideas to form the basis of an explanatory study.

microfinance institution itself, the socio-cultural environment of the region where the microfinance institution located and operates will also be taken into account in the investigation. Second, this study will triangulate quantitative and qualitative data collections and methods of analysis in order to assess the performance and sustainability of a particular microfinance institution which is Village Credit Institutions (LPDs) of Bali and their affecting factors. Third, this study also uses some existing theory to understand and explain what is happening to the LPDs with respect to their performance and sustainability. The intention is not to test theory or to develop new theoretical explanations, but to understand intrinsic aspects of these institutions more thoroughly. Therefore, considering this research problem and the characteristics of case study strategy discussed above, it seems that a combination of intrinsic and explanatory case studies or an intrinsic explanatory case study best describes this study.

5.4 RESEARCH DESIGN

This section presents the type of case study used in this study, the selection of a case, the collection of data, methods of analysis, and the limitations of this methodology.

A field-base case study

The use of case study strategy in conducting business economic research, as mentioned earlier, has been increasing recently. For example, Fuller and Parker (2002) apply a case study strategy to investigate a particular case of the Warai small-business enterprise in the Northern Territory, Australia. They attempt to outline the background and the present operations and circumstances of the Warai[42], including their socio-cultural and economic environments, and outline a strategic business plan for the Warai as an output.

[42] The Warai Pastoral enterprise is a small-business enterprise owned by the Warai association located in 15 kms north of the township of Adelaide river and 100 kms south of Darwin.

In conducting the research, Fuller and Parker (2002) introduce a field-based case study.[43] This is a methodology in the 'involved' research tradition whereby the researchers involve themselves directly in the research site, immersing themselves in the world of the 'actors' (the organisational participants), seeking to understand their context, activities, behaviours, attitude, and processes (Fuller and Parker 2002, p.77). Parker (1994) points out that field research aims to inductively identify and explain concepts, variables, and their relationships as they emerge from observations on site in the field, rather than deductively predetermining them from literature or prior published studies. Following Ahrens and Dent (1998), Fuller and Parker describe the methodology as inherently multi-method in that it typically employs observations, semi-structured interviews, and document analysis. It does not follow a predetermined script as a traditional positivist study, instead being flexible in the application of changing methods and procedures according to the data sources identified and findings gradually made on site (Fuller and Parker 2002, p.77).

This study follows in the footsteps of Fuller and Parker (2002). Fuller and Parker's field-based case study approach seems to be suited for this study, especially for qualitative analysis, in order to explore the nature of the performance and sustainability of the microfinance institution (the LPD of Bali), "why" it performs in this way, and "what" socio-economic factors influence its performance and sustainability.

This study of LPD of Bali conforms to the definition of field research by Ferreira and Merchant (1992), as cited by Fuller and Parker (2002), in that it has involved the study of real (rather than artificially created) tasks and processes, has employed an evolving (rather than wholly pre-structured) research design, and includes relatively rich descriptions of contexts and practices. Fuller and Parker (2002) suggest that field research offers the ability to investigate day-to-day procedures, systems, and outcomes as they are occurring or indeed to identify where they are absent. Phenomena are studied in their real life context rather than being abstracted through postal questionnaires or laboratory settings. In this way, the field researcher aims to penetrate

[43] This is similar to an intrinsic explanatory case study, but its emphasis is on the field based work.

manifest appearances and identify latent behaviours and attitudes and contextual conditioners and drivers. The evolving, semi-structured nature of the field research design allows the researcher to be open-minded and 'surprised' by data discovered in the field, thereby taking up the opportunity to learn from field observations rather than impose some prejudged framework upon them. The rich descriptions of context, settings and practices provide potential insights into interactions between actors' action and the settings in which they take place, from a situational perspective. Such a methodological orientation is particularly suited to organisational settings, which have pronounced cultural dimensions, national, ethnic or organisational. Following Scapens' (1990) point that the case study approach is particularly sensitive to context, field research based case study has been particularly suited to investigating the LPD of Bali.

This single case study has descriptive, exploratory, and explanatory dimensions. It offers descriptive detail in its outline of the background and present operations and circumstances of the LPDs of Bali, particularly in Gianyar district of Bali. Based on this information, it then explores the LPD case with a view to identifying and clarifying key strategic issues, and attempts to explain why some observed outcomes of the LPD have occurred (Scapens 1990; Yin 2003).

The selection of a case

The selection of a case for study is always a crucial step in the field based case study strategy. Scapens (1990, p.272-3) suggests three rationales in selecting a case. First, the case selected can represent a critical case that directly exhibits and addresses key issues that have been well identified and discussed in the subject area under study. This critical case can be used to determine whether a theory's propositions are correct or whether some alternative set of explanations need to developed and might be more relevant. Second, the case can represent an extreme case or a unique case that extends the subject area beyond the limits of its previous observation in circumstances that differ from scenarios previously considered. Third, the exploratory case[44] may be

[44] Yin uses the terms 'representative' or 'typical' case (see Yin, 2003, p.42)

selected for the examination of a subject area on which there is little prior theory or evidence available. Yin (2003, p.42) adds two more rationales, that is, the revelatory case and the longitudinal case. The revelatory case exists when an investigator has an opportunity to observe and analyse a phenomenon previously inaccessible to scientific investigation and the longitudinal case refers to a study of the same case at two or more different points in time.

From those perspectives, the LPD case is an exploratory one. It is 'exploratory' because even though the LPD is considered as a fully sustainable microfinance institution in Indonesia by some scholars (Christen, Rhyne et al. 1995; Chaves and Gonzales-Vega 1996), the LPD represents a microfinance institution that is little understood from the point of view of its socio-cultural context, its management, and other factors influencing its performance and sustainability. More specifically, little is known about the influences of its institutional environment – both formal and informal institution – on the success of the LPD.

Yin (2003, p.42-43) points out that the same case study may involve more than one unit of analysis. In this study, the LPDs are analysed on two levels through an embedded case study design (Yin 2003, p.43). At the first level, this study assesses the performance and sustainability of the LPDs at the district level focusing on Gianyar district. The selection process of Gianyar district as the focus of this study uses purposive sampling strategy based on the research question of this study. As stated in Chapter 1, one of the research questions of this study is to assess whether or not there is any difference between performance of the LPDs located in handicraft industry based region (in this case is sub-districts) and the LPDs located in agricultural based region. The purpose of this study is to investigate the influence of socio-economic context (economic-based) on the performance and sustainability of the LPDs. This assessment is an explorative one since there is no previous study discussing this matter, especially for the case of LPD.

Based on this objective, Gianyar district that is a well-known centre of the handicraft industry in Bali province meets this criterion. Four of its sub-districts are the centres of handicraft industries in Bali (Hofer 1996, p.147-153; Picard 1996, p.60-61; IPB and Indonesia 1999). They are Sukawati sub-district as the centre of stone and wood carving and silver and goldsmithing, Ubud sub-district as the centre of wood carving, masks, and paintings, Tegallalang as the centre of masks and wood carving, and Gianyar sub-district as the centre of textiles, paintings, and wood carving. Most of the products of the industries, such as woodcarved mirror frames, boxes and small cabinets, masks, furniture, silver and gold (for example: brooches, earrings, and earclips), and textiles (*kain ikat*), are produced using domestically raw materials. The other sub-districts – Blahbatuh, Tampak Siring, and Payang – are predominantly reliant on the agricultural sector. In addition, the selection of Gianyar district was also influenced by the ease of access of the researcher to the sample region.

At the second level, this study assesses the performance and sustainability of the LPD at firm (unit) level in order to better understand the factors affecting the performance and sustainability of the LPD and to develop some elements of a business plan for the LPD unit being studied for enhancing their development in the future. The detailed reasons for creating some elements of a business plan are discussed in the last part of this chapter. Two LPD have been chosen as representative of those two different regions are the LPD of Mas village (handicraft industry based region) and the LPD of Kerta village (agricultural based region). The two LPDs were also selected through purposive sampling strategy based on the value of asset and accessibility to be the sample of this study. In terms of asset, the LPD Mas is the largest LPD in Gianyar with the asset of Rp7 billion in 2001, while the LPD Kerta has an asset of Rp1.4 billion in 2001 (PLPDK 2001), and is the fourth largest LPD in an agricultural based village, and the largest that could be accessed for this study.

The collection of data

As noted earlier, this study of the LPD employs multiple methods of data collection: physical site inspection (direct observation) at the LPD location, interviews with the

stakeholders of LPDs, and archival document (published and unpublished documents) analysis – all conducted in four months of two fieldwork periods. In the qualitative research tradition, this affords the opportunity for more extensive data access, reduced observer bias, and triangulation, which enhanced the validity and reliability of findings (Layder 1993; Silverman 2001, p.233-235). Thus, cross validation of data is facilitated, as well as the combination of contextual and temporal observations with actors' interpretations of their socioeconomic world and roles obtained from interviews (Piore 1979, p.566). Application of these multiple methods also allows the researcher to gain access to tacit knowledge inherent in organisation members' daily routine and implicit in their working knowledge about the way in which an enterprise operates. Dawson (1997) argues, cited by Fuller and Parker (2002), that this tacit knowledge is gained directly from enterprise members and from the researcher's own direct observation of physical artefacts, activity and documentary records, and is done with a view to also penetrating the substance, context and politics of organisational activity (Fuller and Parker 2002, p.79). This method of data collection has been approved by the ethics committee of Flinders University.

The fieldwork of this study was conducted in two parts, the first being from early December 2001 until the end of March 2002 and the second in March 2003. During this fieldwork, five governmental offices in Bali - including Bali Provincial Office (Governor's office), the Branch Office of Bank Indonesia (the Central Bank), Bank BPD of Bali (Head Office), the Central Board of Statistics (CBS) of Bali Province, and the CBS of Gianyar District – were visited. In addition, over the period of the fieldwork, the LPD of Mas village and the LPD of Kerta village in Gianyar district of Bali were also visited.

The second fieldwork was conducted from mid February to the end of March 2003. This second fieldwork aimed to complete the data required and to get more information through in-depth interviews with the managers and stakeholders of the LPDs by using questionnaires in Appendix 5, 7, and 8. This fieldwork emphasised on the two LPDs

that will form the basis of a comparison, that is, the LPD Mas village and the LPD Kerta village.

In the fieldworks, quantitative data were collected from secondary sources (e.g. published data, unpublished documents, and financial reports) and qualitative data were collected through interviews with stakeholders of the LPDs by using a semi-structured questionary (Appendix 5, 7, and 8). The quantitative data are mainly used for assessing the performance and sustainability of the LPDs and the influence of socio-economic condition on them. The qualitative data are used to deepen the analysis and to outline some elements of business plans of the LPD unit being studied. The use of a semi-structured interview tool in this study since the semi-structured interviews are the most appropriate for ascertaining interviewee's perceptions, interpretations and explanations of their roles and organisational activity (Yin 2003, p.90). Interviewees were selected through a purposive sampling strategy, which combined the targeting of individuals who were strategically important to the LPD while at the same time focusing upon emerging issues that appeared important to the phenomenon under investigation (Strauss and Corbin 1990; Miles and Huberman 1994). The list of interviewees is presented in Appendix 3.

Methods and tool of analysis

As noted earlier, this study applies mixed methods of analysis (triangulation) in addressing the problems of study by using both quantitative and qualitative methods. Quantitative analysis uses a statistical analysis including test for the Mann-Whitney *U* test and multivariate analysis. Qualitative analysis uses SWOT analysis. These tools are described below.

(1) Quantitative analysis

As noted earlier in the selection of case section, the selection of Gianyar district as the focus of this study is based on one of the objectives of this study - which is to investigate the influence of socio-economic condition on the performance and sustainability of the LPDs (purposive sampling) - and the accessibility of the researcher

to the sample. At the end of 2001, it has been recorded that 174 LPDs have been established in Gianyar district and they were spread all over seven sub-districts. There are 103 LPDs located in four sub-districts which are the centre of handicraft industries as mentioned earlier (handicraft-based sub-districts) and 71 located in three agricultural-based sub-districts as shown in Table 5.1.

The data for this quantitative analysis were collected during conducting two fieldworks. The dataset used as the basis for calculation and analysis of performance indicators are mainly based on financial reports of the LPDs of the Gianyar district in 1999 and 2001 because of the limitations of time and other resources, and to omit the influence of Indonesian economic crisis before 1999. Hence, this study only focuses on the condition of the LPD in the period of 1999-2001 when the economic situation of Bali was stable. The economic situation after 2001 — that might have changed — is outside the scope of this study. The data from income statements includes operating income, operational cost (expenses), labour cost (salary), net income (profit), and provision for loan losses. From balance statements, it is possible to ascertain the total assets, current assets (loan outstanding and credit default), fixed assets, client savings, client time deposits, capital, and equity. In addition, other related data such as the number of client data (including borrowers, savers, and depositors), the data on population and Gross Regional Domestic Product (GRDP) of Gianyar district and its sub-districts from the Central Board of Statistics of Gianyar district are also used in this analysis.

Table 5.1 Number of LPDs in Gianyar District by Sub-districts and Economic Characteristic, 2001

No.	Sub-district	Number of LPD	Economic characteristics
1	Sukawati	26	Handicraft industry
2	Gianyar	28	Handicraft industry
3	Ubud	24	Handicraft industry
4	Tegallalang	25	Handicraft industry
	Sub-total (a)	(103)	
5	Blahbatuh	25	Agriculture
6	Tampaksiring	23	Agriculture
7	Payangan	23	Agriculture
	Sub-total (b)	(71)	
	TOTAL (a + b)	174	

Source: PLPDK, *Financial Report of LPD Gianyar District of Bali Province*, 2001

❖ **The Mann-Whitney U Test**

After conducting the normality test for the data (using Lilliefors test[45]), the results reveal that the performance indicators data are not normally distributed. This means that the normality requirement necessary to perform the equal-variances *t*-test of $\mu1 - \mu2$ is unsatisfied for all performance indicators. In these circumstances, the use of techniques that do not make restrictive assumptions about the shape of population distributions will be useful (Levin and Rubin 1994; Newbold 1995; Keller and Warrack 2000). These are known as distribution-free statistics or, more commonly, nonparametric tests.

As mentiond earlier in Chapter 1, one of the research questions of this study is to examine whether the performance indicators of two populations of LPDs (LPDs located in handicraft industries based and agricultural based sub-districts) are alike or different. This assessment aims to asses the influence of socio-economic context on the performance and sustainability of the LPDs. Since this assessment uses quantitative

[45] The procedure of this test is presented in the Appendix 4. This test is suited for this case since the population data which mean and standard deviation are unknown. A test for normality of Kolmogorov & Smirnov is not relevant to this case since it assumes that the mean and standard deviation of population is known (Keller & Warrack, 2000, p.614).

data, independent samples, and different number of samples, the use of the Mann-Whitney U test is an appropriate one (Levin and Rubin 1994, p.719; Newbold 1995, p.395; Gravetter and Wallnau 1996).[46] The performance indicators that will be tested include portfolio quality (repayment rate and delinquent borrowers ratio), leverage (debt to equity ratio), capital adequacy ratio (CAR), productivity ratio (for instance, number of active borrowers per staff and loan outstanding per staff), efficiency (operating cost ratio and salary as percentage of average portfolio outstanding), profitability (return on asset and return on equity), financial viability (operational self-sufficiency and financial self-sufficiency), and outreach (for instance, number of borrowers and savers, average loan per LPD, average savings per LPD). As noted earlier, the importance of testing this hypothesis is to investigate whether or not different socio-economic conditions have a significant influence on the performance and, in turn, on the sustainability of the LPDs. Following those authors, the step of conducting this test is as follows.

Suppose that $n1$ observations are available from the first population (LPDs located in handicraft industries based regions) and $n2$ from the LPDs located in agricultural based regions, and let $R1$ and $R2$ denote the sum of the ranks of the observations from the first and the second population respectively. The U statistic for the first population is then defined as

$$U1 = n1n2 + \frac{n1(n1 + 1)}{2} - R1$$

and for the second population,

$$U2 = n1n2 + \frac{n2(n2 + 1)}{2} - R2$$

[46] Another test for independent samples is the Kruskal-Wallis test. This test is an extension of the Mann-Whitney test to situations where more than two populations are involved (Levin & Rubin, 1994).

In testing the null hypothesis that the central locations of the two population distributions are the same, we assume that apart from any possible differences in central location, the two population distributions are identical. It can be shown, then, that if the null hypothesis is true, the *U* statistic has a sampling distribution with a mean of

$$E(U) = \mu_U = \frac{n_1 n_2}{2}$$

and variance

$$Var\ (U) = \sigma_U^2 = \frac{n_1 n_2 (n_1 + n_1 + 1)}{12}$$

The sampling distribution of the U statistic can be approximated by the normal distribution when both n_1 and n_2 are larger than 10. Since the samples number of this study - $n_1 = 103$ and $n_2 = 71$ - meets this condition, the standard normal probability distribution table can be used for the testing hypothesis. The hypothesis testing procedure for examining whether the performance of the two groups of LPDs - for instance, the repayment rate - from different regions are alike or different is presented below:

H_0:	$\mu_1 = \mu_2$	null hypothesis: There is no difference between the two populations of LPDs, and so they have the same mean of repayment rate.
H_1:	$\mu_1 \neq \mu_2$	alternative hypothesis: There is a difference between the two populations of LPDs; in particular they have different means of repayment rate.
$\alpha = 0.05$		level of significance for testing these hypotheses

Using a two-tailed test, the acceptance region of the *U* statistic (the Mann-Withney *U* test) is determined at the 0.05 level of significance (since the sample is larger than 30, the *z* table is used). When the *U* calculated lies outside the acceptance region, the null hypothesis of no difference is rejected and it can be concluded that the distributions, and hence the mean of repayment rates at the two regions are different.

There have been some advantages to using this nonparametric method in a research (Berenson and Levine 1986, p.531-532; Levin and Rubin 1994, p.711-712; Newbold 1995, p.399). First, nonparametric methods may be used on all types of data – qualitative data (nominal scaling), data in rank form (ordinal scaling), as well as data that have been measured more precisely (interval or ratio scaling). Second, depending on the particular procedure selected, nonparametric methods may almost, or even equally, be as powerful as the classical procedure when the assumptions of the latter are met, and they may be quite a bit more powerful when the assumptions of the classical procedure are not met. Third, nonparametric methods are generally easy to apply and to understand. Fourth, nonparametric methods make fewer, less stringent assumptions (which are more easily met) than do the classical procedures. Hence, they enjoy wider applicability and yield a more general, broad-based set of conclusions.

These methods may be advantageously employed in a variety of situations. However, they also have some disadvantages. For instance, nonparametric methods are rather difficult to apply to the problems that involve complex model building (Newbold 1995, p.399). In addition, nonparametric methods are often not as efficient or "sharp" as parametric tests (Levin and Rubin 1994, 712). The estimate of an interval at 95 percent confidence level using a nonparametric test may be twice as large as the estimate using a parametric test. When using nonparametric tests, there is a trade-off: loosing sharpness in estimating interval, but gaining the ability to use less information and to calculate faster.

❖ Multivariate analysis: binomial logistic model

The repayment rate is the most important performance indicators of microfinance institution (Yaron 1994; Sharma and Zeller 1997; Christen 1998; Zeller 1998; Woolcock 1999). As Woolcock (1999) points out, the most common measure of a microfinance program's performance is its loan repayment rate, since this has a large bearing on whether a program is likely to be financially sustainable. Yaron (1994), as noted in Chapter 2, also emphasises that a high profit earned by microfinance institutions cannot be used as the only indicator of self-sustainability of the institutions, since a high profit could be attained just in the short period only. Attaining a high rate of loan collection (repayment rate) is a necessary condition for a microfinance institution to become self-sustainable in the long run. Loan losses often have been the largest cost borne by the institutions and the principal cause of insolvency and illiquidity.

This study employs a multivariate analysis in assessing the factors influencing the repayment rate. Since the datasets are not normally distributed and the repayment rate is a continuous variable, an ordinary least squares model will lead to inefficient parameters estimates, because of heteroscedasticity problem (Maddala 1983, p.16). Alternatively, following Goldberger (1964), Maddala (1983) suggests the use of binomial or binary choice model[47] - such as probit (or the normit model) and logit model - to overcome the problems because it uses a dummy variable (for the repayment rate) instead of a continuous variable. The probit and logit models usually give similar results and it is difficult to distinguish them statistically, since the cumulative normal distribution of probit model and the logistic distribution are very close to each other (Amemiya 1981, p.1502; Maddala 1983, p.23; Amemiya 1985, p.309-310; Tabachnick and Fidell 2001, p.536). However, the assumption that underlying distribution is normal makes probit analysis somewhat more restricted than logit analysis. Hence, the logit analysis is considered better than probit analysis if there are too many cases with

[47] These binary-choice models are regression models using discrete dependent variable and involving two or more qualitative choices. These models assume that individuals are faced with a choice between two alternatives and that their choice depends on their characteristics.

very high or very low probabilities so that an underlying normal distribution is untenable (Tabachnick and Fidell 2001, p.536). The logit model has another advantage over the probit model which is the ease of numerical calculation, as a logistic function is much easier to calculate that the cumulative normal function of the probit model (Amemiya 1981). In addition, the logit model can be used without any change even with unequal sample sizes (Maddala, 1992, p.330-331). For these reasons, this study estimates the model by using the logistic model (logit).

The logit model is based on the cumulative logistic probability function and is specified as (Pindyck and Rubinfeld 1991)

$$Pi = F(Z_i) = F(\alpha + \beta X_i) = \frac{1}{1 + e^{-zi}} = \frac{1}{1 + e^{-(\alpha + \beta Xi)}}$$

where e represents the base of natural logarithms, which is approximately equal to 2.718. Pi is the probability of a certain event, given Xi. The first step to estimate the model is both sides of the model is multiplied by $1 + e$–zi to get

$$(1 + e^{-zi})P_i = 1$$

Dividing by P_i, and then subtracting 1 leads to

$$e^{-zi} = \frac{1}{P_i} - 1 = \frac{1 - P_i}{P_i}$$

By definition, however, $e^{-zi} = 1/e^{zi}$, so that

$$e^{-zi} = \frac{P_i}{1 - P_i}$$

Now, by taking the natural logarithm of both sides,

$$Z_i = \log \frac{P_i}{1 - P_i}$$

or

$$\log \frac{P_i}{1 - P_i} = Z_i = \alpha + \beta X_i$$

Since Pi is the probability of being one group, and $(1 - P_i)$ is the probability of being other group, the ratio $P_i/(1 - P_i)$, known as odds ratio, is simply the odds in favour of an event A. The natural log of this odds ratio is called the logit, and therefore the model is called the *logit model*. X_i is the vector of independent variables for the *i*th observation; α is the intercept parameter; and β is the vector of coefficient parameters.

The procedure of estimating coefficients is maximum likelihood techniques[48] (Amemiya 1981, p.1493-1499; Tabachnick and Fidell 2001, p.518), and the goal is to find the best linear combination of predictors to maximize the likelihood of obtaining the observed outcome frequencies. A positive and significant estimated coefficient would imply that an increase in the value of the particular explanatory variable is associated with an increased probability of the dependent variable taking the value one. Given the exploratory nature of the analysis, the reliance on imperfect proxies and the non-linear relationship between the dependent and independent variables, no attempt has been made to interpret the magnitudes of the coefficients of the explanatory variables. Rather, the analysis focuses on the signs and significance of the estimated coefficients. Collinearity diagnostics are performed on each set of explanatory variable employed in the model, to ensure that multicollinearity is not adversely affecting the estimation of the coefficients

[48] Maximum likelihood estimation is an iterative procedure that starts with arbitrary values of coefficients and determines the direction and size of change in the coefficients that will maximize the likelihood of obtaining the observed frequencies (Tabachnick & Fidel, 2001, p.518).

The logit model is used to study the repayment rate (RR) of 154 LPDs in Gianyar district, in 2001. Since the repayment rates in this study are continuous variable, they are converted to a discrete variable. In this model, *Pi* is probability of LPDs having repayment rates "above" average of repayment rate of its population, (1 – *Pi*) is a probability of LPDs having repayment rates "below" average of repayment rate of its population.

$$
y_i = \begin{cases} 1, & \text{if the repayment rate is "above" average} \\ 0, & \text{otherwise} \end{cases}
$$

Hence the logit model becomes

$$
\log \frac{\text{Prob (RR>above)}}{1 - \text{Prob (RR>above)}} = Z_i = \alpha + \beta X_i
$$

The repayment rate is expected to be influenced by a range of explanatory variables that reflect program-specific and community socio-economic characteristics. The expected signs for the parameters coefficient are shown in Table 5.2. The independent variables are as follow. First, OUTSTL is a total balance of outstanding loans of each LPD (in Rupiah). The hypothesis is the higher total balance of outstanding loans of the LPD, the higher its repayment rate. This is because the greater the loan size put pressure on the borrower to reduce the delinquency rate (Sharma and Zeller 1997, p.1738). Second, NUMBOR is number of clients (borrowers) of each LPD. The hypothesis is the larger number of clients of a microfinance institution, the lower its repayment rate. The larger number of borrowers could arise asymmetric information problem and make monitoring and enforcing costly and less effective.

Third, NUMSAVER is the number of savers. The hypothesis is the higher number of savers in microfinance institution, the higher its repayment rate. The number of savers

(and savings) is an essential element for improving the repayment rate since savers may indicate the banking mindedness and the financial disciplines of clients (Zeller 1998, p.614). Fourth, NUMSTAF is number of staff, which is measured by number of staff of each LPD. The hypothesis is the larger number of staff in the LPDs, the higher its repayment rate. It is expected that a larger number of staff in the LPDs will result in a better repayment rate, since they would be able to manage the LPDs better.

Fifth, WEALTH (dummy) is a dummy variable for the wealth index of the clients. It is hypothesised that the wealth of clients has a positive and significant relationship with the repayment rate (Zeller 1998, p.615). This study uses GRDP per capita as a proxy of the wealth. This variable equals one if the LPDs located in sub-districts having GRDP per capita "above" the GRDP per capita of the district and zero when the LPDs located in sub-districts having GRDP per capita "below" average of the district. Sixth, DUMVIL (dummy variable for region) is a control variable for the economic base of villages that might influence the repayment rate (Zeller 1998, p.613). The hypothesis is there will be a significant relationship between the economic base of a village and the repayment rate of the LPD in that village. This variable has the value of one if the LPD is located in small-scale industries based village and zero when it is located in agricultural based village. It is expected that the repayment rate is affected by the client's occupation, in particular, whether he or she is employed in the agricultural sector or in small-scale industry. Table 5.2 summarises the independent variables and expected signs for the ordinary least square model. Based on theory and *trial and error* process using SPSS program the best specification model of the repayment rate is as follows:

$$\log \frac{\text{Prob (RR>above)}}{1 - \text{Prob (RR>above)}} = \alpha + \beta 1\text{OUTSTL} + \beta 2\text{NUMBOR} + \beta 3\text{NUMSAVER} + \beta 4\text{NUMSTAF} + \beta 5\text{WEALTH} + \beta 6\text{DUMVIL}$$

Table 5.2 Independent Variables and Expected Signs of Logit Model for the Repayment Rate of the LPDs

Independent Variable	Expected Sign
Outstanding loans (OUTSTL)	+
Number of borrowers (NUMBOR)	-
Number of savers (NUMSAVER)	+
Number of staff (NUMSTAF)	+
Wealth index (WEALTH)	+
Dummy regions (DUMVIL)	*

Note: * = no a priori expectation for sign direction

(2) A SWOT Analysis

After analysing the performance and sustainainability of the LPDs, it will be very useful to outline some elements of a strategic business plan for the LPD unit being studied to meet one of the objectives of this study as mentioned in Chapter 1. The creation of some elements of business plan is expected to have some benefits for the future development of the LPD unit being studied.

The process of creating a strategic business plan or strategic planning refers to a process of discovery and awareness creation of an enterprise to envision its future and develop the necessary procedures and operations to achieve that future as environmental (market place) changes are identified and related to relevant enterprise strengths and weaknesses (Flavel and Williams 1996; David 2001; Thompson and Strickland III 2001; Fleisher and Bensoussan 2003; Pearce II and Robinson 2003; Kuratko and Hodgetts 2004). Thus, the strategic planning process involves more than simply extrapolating current trends or predicting and anticipating the future. It represents a process through which organisation members attempt to create their future, but with due regard paid to the realities of their external environment and internal capabilities. The aim of creating a strategic business plan is to improve on how an enterprise is operating today and the need for actions to prepare for future's markets and changing environment conditions (Thompson and Strickland III 2001, p.16). A study (Hopkins and Hopkins 1997) reveals that a strategic business plan has direct, positive effect on banks' financial performance, and mediates the effects of managerial and organisational factors on banks' performance. This is also relevant to microfinance

institutions, which is one type of small banks. The business plans of this study will be derived from the field research in the LPD Mas and the LPD Kerta, as well as from institutional and financial performance analyses of the LPDs presented in Chapter 6 and 7.

Generally the strategic planning process involves three activities that are strategy formulation, strategy implementation, and strategy evaluation (David 2001, p.5-6). As noted in Chapter 1, strategy formulation is the focus of the strategic planning activities in this study since the last two activities – strategy implementation and strategy evaluation - are beyond the scope of this study. The strategy formulation activity includes defining the enterprise's mission, specifying achievable objectives, and developing strategies (some elements of business plan) to enable accomplishment of objectives (Flavel and Williams 1996, p.4; Thompson and Strickland III 2001, p.17).

A mission statement of an enterprise is a unique purpose that sets it apart from other companies of its types and identifies the scope of its operations. The mission statement describes the enterprise's product, market, and technological areas of emphasis in a way that reflects the values and priorities of the strategic decision makers (Pearce II and Robinson 2003, p.13). David (2001, p.9) and Pearce II and Robinson (2003) point out that since social responsibility is a critical consideration for an enterprise's strategic decision makers, the mission statement must express how the enterprise intends to contribute to the societies that sustain it and distinguish one business from other similar firms. In a slightly different but essentially similar ways, David (2001, p. 9) defines mission statements are as enduring statements of purpose that distinguish one business from other similar firms. A mission statement identifies the scope of a firm's operations in product and market terms. It addresses the basic question that faces all strategists: What our business? A clear mission statement describes the values and priorities of an organisation (Kaplan and Norton 2004, p.43). Developing a mission statement compels strategists to think about the nature and scope of present operations and to assess the potential attractiveness of future markets and activities. A mission statement broadly charts the future direction of an organisation. In short, a mission statement defines what

business the enterprise is *presently* in and conveys the essence of "who we are, what we do, and where we are now" (Thompson and Strickland III 2001, p.32).

Objectives can be defined as specific results that an organisation seeks to achieve in pursuing its basic mission (David 2001, p.11). The purpose of setting objectives is to convert managerial statements of business mission into specific performance targets – results and outcomes the organisation wants to achieve. David (2001) argues that objectives should be challenging, measurable, consistence, reasonable, and clear. Thompson and Strickland III (2001, p.9-10) suggest that an enterprise management has to set financial objectives and strategic objectives. Financial objectives concern the financial results and outcomes that management wants the organisation to achieve, such as profitability and productivity. Strategic objectives aim at results that reflect increased competitiveness and stronger business position, such as relative dominance in the marketplace.

Strategies are the means by which long objectives will be achieved. An enterprise's strategy represents management's answers to fundamental business questions such as concentration on single business, diversification, geographic expansion, product development, and market penetration (David 2001, p.11; Thompson and Strickland III 2001, p.10). Thompson and Strickland III (2001, p.12) point out that enterprise strategies concern *how*: "how to grow the business, how to compete rivals, how to respond to changing market conditions, how to manage each functional piece of the business and develop needed organisational capabilities, how to achieve strategic and financial objectives." However, it is worth bearing in mind that the essence of strategy is in the activities – choosing to perform activities differently or to perform different activities than rivals -, otherwise a strategy is nothing more than a marketing slogan that will not withstand competition (Porter 1996, p.64). Hence, the formulated strategies have to be based on the analysis of both external and internal factors facing

the enterprise the so-called SWOT (Strengths, Weaknesses, Opportunities, and Threats) analysis.[49]

A SWOT analysis is conceptually simple and comprehensive and it can be applied to many facets of an organisation. These factors have made it one of the most popular models, particularly for determining an organisation's ability to deal with its environment (Fleisher and Bensoussan 2003). SWOT is part of a more encompassing analysis of an organisation's situation which is viewed as one of the fundamental elements of strategy formulation (Weihrich 1982; Thompson and Strickland III 2001; Fleisher and Bensoussan 2003). Situation analysis typically consists of both external (macroenvironment) and an internal (microenvironment) component (Weihrich 1982; Fleisher and Bensoussan 2003). Environmental analysis is the process of scanning and monitoring the environment to identify both present and future positive (opportunities) and negative trends (threats) that may influence the firm's ability to reach its performance goals. This means that SWOT analysis is a means of searching for insights into ways of crafting and maintaining a profitable fit between a business entity and its environment (Ansoff 1975; Porter 1979).

Fleisher and Bensoussan (2003, p.96-7) point out some strengths and advantages of SWOT analysis. First, SWOT analysis has a wide applicability. It can be used for analysing a variety of units, including but not limited to individual managers or decision makers, teams, project, product/services, function areas of the organisations (i.e., marketing, operations, and sales), business units, corporations, and product markets. It works equally well for profit or non-profit organisations. Second, SWOT analysis does not require a great deal of financial or computational resources and can be done both quickly and with some degree of efficacy without the necessity of of extensive information acquisition. Third, it can provide the impetus to analyse situation. It can also offer an enhanced way of thinking through the range of viable tactics or strategies for responding to an organisation's competitive environmental

[49] In 1971, Ken Andrews – the pioneer of SWOT (Strengths, Weaknesses, Opportunities, and Threats) analysis – was one of the first strategy theorists to formally articulate the concept of strategic fit between the firm's resources and capabilities with the external environment.

dynamics. Fourth, SWOT analysis can be an effective team-building method when performed jointly by functional specialists from marketing, operation, finance, and so on. Lastly, SWOT analysis can provide insight into why a particular organisation has been successful or unsuccessful in carrying out its strategy.

Despite its strengths and advantages, SWOT analysis has also some weaknesses and limitations (Hill and Westbrook 1997; Fleisher and Bensoussan 2003). First, the SWOT analysis is descriptive model and it does not offer the analyst explicit strategic recommendations. SWOT analysis cannot give the decision maker specific answers. It is only a way to organise information and allocate probabilities to potential events as the basis for developing business strategy and operational plans. Second, the inherent simplicity of SWOT disguises a great deal of complexity. The primary concerns for the analyst who must conduct a situation analysis are collecting and interpreting a lot of data about the most significant environmental forces, and then deciding what to do in response to them. Interpretation represents a form of judgment and will likely differ between individual managers. Third, detractors of this model criticise the limited ability of SWOT analysis to prescribe specific actions to be followed by an organisation. Since the individual complexities of business, the general reccomendations need to be organised to a high level of abstraction. Lastly, other critics of SWOT analysis emphasise its reliance on qualitative rather than quantitative data, its focus on creating reactive rather than proactive strategies, and its simplification in distinguishing between strengths and weaknesses, and opportunities and threats.

Even though there have been criticisms concerning the use of SWOT analysis in business research, it is still very useful since it has been enhanced through improvement of the original SWOT concept (Koch 2000). The improvement includes provision of some practical guidelines and a sequence of steps in conducting the SWOT analysis (Johnson, Scholes et al. 1989).

❖ **Process of applying SWOT analysis in this study**

It is argued that the quality of strategy formulation of the entire plan of an enterprise (e.g. LPD) depends on the quality of the SWOT analysis (Flavel and Williams 1996; Thompson and Strickland III 2001; Pearce II and Robinson 2003). The first step in utilising a SWOT analysis in this study is to evaluate existing and possible future strategies involves listing and evaluating the strengths, weaknesses, opportunities, and threats of the LPD unit being studied by using SWOT internal checklist in Appendix 5. Relevant SWOT factors are identified and summarised from an analysis of the internal LPD and its external socio-economic environment. An internal analysis of management and business functions will result in a list of statements about the LPD, which may be interpreted as either strengths or weaknesses. These strengths and weaknesses are made up of factors over which it has greater relative control by the enterprise (Flavel and Williams 1996; Fleisher and Bensoussan 2003).

Strengths are those factors that make an enterprise more competitive in its marketplace (Weihrich 1982; Thompson and Strickland III 2001; Fleisher and Bensoussan 2003). Strengths can be in the form of skill or important expertise (for instance, expertise in providing consistently good customer service or unique advertising and promotional talents), valuable human assets (for instance, an experience and capable workforce or motivated and energetic employees), valuable organisational assets (for instance, a base of loyal customers or a strong balance sheet and credit rating), valuable intangible assets (for instance, image, company reputation, buyer goodwill, or a motivated and energised workforce), competitive capabilities (for instance, a high degree of organisational agility in responding to shifting market conditions and emerging opportunities), and an achievement or attribute that puts the company in a position of market advantage (for instance, low overall costs, market share leadership, a superior product, or strong name recognition).

A weakness is a limitation, fault, or defect within an enterprise that will keep it from achieving its objectives. It is what an enterprise does poorly or where it has inferior capabilities or resources as compared to the competition. Thompson and Strickland III

(2001) point out that an enterprise's internal weaknesses can relate to "deficiencies in competitively important skills or expertise or intellectual capital of one kind or another; a lack of competitively important physical, organisational, or intangible assets; or missing or weak competitive capabilities in key areas." A weakness may influences an enterprise's competitiveness. The magnitude of the influence depends on how much the weakness matters in the marketplace and whether it can be overcome by the resources and strengths owned by the enterprise.

An external analysis of management and business functions will result in a list of statements of opportunities and threats by using external SWOT checklist in Appendix 5. These enterprise's opportunities and threats are made up of factors over which the enterprise has lesser relative control (Flavel and Williams 1996; Fleisher and Bensoussan 2003). Opportunities include any favourable current or prospective situation in the enterprise's environment, such as trend, change, or overlooked need, that supports the demand for a product or service and permits the enterprise to enhance its competitive position. Thompson and Strickland III (2001) point out that market opportunity is a significant factor in shaping an enterprise's strategy. Managers cannot properly create strategy that suit to the enterprise's situation without first identifying each enterprise opportunity and appraising the growth and profit potential each one holds. Thompson and Strickland III (2001) also point out that the most relevant market opportunities to an enterprise are "the opportunities that offer important chances for profitable growth, those where an enterprise has the most potential for competitive advantage, and those that match up well with the enterprise's financial and organisational resource capabilities."

A threat includes any unfavourable situation, trend or impending change in an enterprise's environment that is currently or potentially damaging or threatening to its ability to compete. It may be a barrier, constraint, or anything that might inflict problems, damages, harm or injury to the enterprise. Thompson and Strickland III (2001, p.127) point out that "threats can stem from the emergence of cheaper or better technology, rivals' introduction of new or improved products, new regulations that are

more burdensome to an enterprise than to its competitors, vulnerability to a rise in interest rates, and the like." The opportunities and threats not only influence the attractiveness of an enterprise's situation but, more important, they point to the need for strategic action. Thompson and Strickland III (2001) also argue that creating strategy to an enterprise's situation involve "pursuing market opportunities well suited to the enterprise's resource capabilities and taking actions to defend against external threats to the enterprise's business." The opportunities and threats include, among others, overall demand, the degree of market saturation, intensity of competition, threat of substitute products, government policies, economic conditions, social, cultural, and ethical developments, technological developments, and the like.

The methodology used to gather and interpret this information in this study is through an interrelated, iterative, and reinforcing process of consultation with managers of the LPD, the Commissioner Board of the LPD, clients of the LPD, and other stakeholders of the LPD such as officers of Bank BPD Bali and government official who involve in giving supervision and guidance to the LPD. The data and information collected comprising facts and impressions and opinions from field study will be condensed into a meaningful picture that includes the main important strengths, weaknesses, opportunities, and threats. In this analysis, there are some elements of importance that must be categorised and scored.

In categorising and scoring the some elements of importance, this study applies Flavel and Williams' (1996) weighted scoring methodology. It is expected that this methodology is appropriate to this study for two reasons. First, this methodology is quantifiable and measurable as shown in Table 5.2, while other SWOT methods only use diagram and qualitative approach. Second, this methodology has been applied to small-scale enterprises (SMEs) – which is the case of the LPD - many times and found to be very effective in encouraging SMEs to move away from a simple recitation of strengths, weaknesses, opportunities, and threats to a marginally more detailed, analytical method (Flavel and Williams 1996, p. 41). However, in this scoring methodology, of course, the subjectivity of the analyst sometimes emerges since in

response to collecting and interpreting data about the most significant environmental forces, as noted earlier, interpretation represents a form of judgment and will likely differ among individual stakeholders.

Table 5.3 SWOT Scoring Interpretation

SWOT Score %	Interpretation (of S, W, O, or T)
90-100	Extremely high
80-89	Very high or obvious
70-79	High or obvious
60-69	Significant element of one of the above
50-59	Partial
40-49	One or two areas only of one of the above
30-39	Very little
20-29	Hardly any
0-19	None

Adapted from: Flavel and Williams, 1996, p.46

Each major category identified for the LPD is weighted in importance against the other strength categories out of total score of 1.0. The score and weight determination of each category is based on consultation and discussion with stakeholders of the LPDs including the managers, the member of Commissioner Board, the clients, the officers of Bank BPD Bali, and the government official. This weighting process is repeated for each of weaknesses, opportunities, and threats. Each individual strength, weakness, opportunity, and threat is also given a percentage score (out of a maximum 100 percent) to indicate its estimated degree of intensity as shown in Table 5.2 (Flavel and Williams 1996, p.46). An average intensity percentage score is computed for each major category within strengths, weaknesses, opportunities, and threats and then multiplied with the importance weighting attributed to the relevant category to produce a weighted intensity for that category. This then provides a basis for assessing the relative significance to the LPD of particular categories of strength, weakness, opportunity, and threat. It also allows for the deduction of total weakness scores from total strength scores, and total threats scores from total opportunities scores, thereby allowing a diagnosis of the extent of positive strategic potential inherent in the LPD. The procedure of this scoring process is presented in Appendix 5. Finally, the

implication of final score on strategies to be taken follows Flavel and Williams' (1996, p.47) methodology as follows:

For Plus Scores

0-40	Some advantages, but further work required before committing resources
41-60	Considerable advantage. Appears to be well placed although further analysis is recommended
61-80	Excellent advantages with need to concentrate in only a few areas
81-120	Appears to be ready for immediate implementation

For Minus Scores

0-40	Some disadvantages, but further analysis required before proceeding
41-60	Considerable disadvantage. Considerable analysis required before proceeding.
61-80	Poor case but may be confined to a few areas. Attempt to correct these before proceeding.
81-120	Severe disadvantage in a large number of areas. Unlikely to be successful.

Towards policy recommendations

In this particular LPD case study, substantive conclusions will be drawn about its self-sustainability as a microfinance institution and about its potential for providing a model to be followed by other microfinance institutions in Indonesia. Those conclusions and recommendations are substantiated as valid for this particular microfinance institution. Nevertheless, there are most likely elements that are shared with other microfinance institutions, which can be developed in the form of more broadly applicable formal approaches to microfinance institution planning, control and general management (Silverman 2001).

While field based case study strategy does not seek to mimic the generalisable findings from a questionnaire survey of a large sample of respondents from a population, it nonetheless offers the prospect of theoretical rather than statistical generalisations. When case studies are properly undertaken, they should not only fit the specific individual, group, or event studied, but also offer insights that can be transferred to

similar individuals, groups, and events (Berg 1998, p.218). The case that provides convincing observations and explanations will be retained as a key source of insight into concepts, their relationship and an explanatory of cause and effect at the micro level. It offers the policy makers an understanding of individual differences and unique, particular processes at the individual enterprise level – something that is inaccessible to the decision maker who relies solely upon the necessarily general findings of statistically survey results that can only provide predictions of majority attitudes or behaviour at macro-superficial level of research questions to which any survey is limited. Thus a case study of the type offered here provides an expansion of our understandings that can be obtained from empirical observations by offering rich detail in an actual enterprise context (Scapens 1990).

The advantage of this case study research strategy lies in its revealing the microfinance institution as a unique fusion of social, cultural, and economic processes. "Scientifically" derived general laws and statistical generalisations from a large-scale survey may or may not apply to the case of a particular organisation and may not explain its peculiar circumstances. Understanding and explanation on an enterprise's success or failure and identification of its available strategic alternatives must ultimately come from addressing the unique holistic characteristics of that particular case (Scapens 1990). The application of field based case analysis to microfinance institutions offers the prospect of capturing situational data and perspective that may prove crucial to the likely effectiveness of any policies or strategies formulated for the institutions. Fuller and Parker (2002) argue that this type of analysis provides a safeguard against the tendency to ask the wrong questions, to ignore important variables and relationships, or to simplistically model a complex entity and its processes. Instead, in the microfinance institution context, field research can offer the possibility of better recognising the distinctive qualities, inherent limitations and potential strategic advantages of a microfinance institution.

CHAPTER SIX

THE ROLE OF INSTITUTIONS IN THE MANAGEMENT OF VILLAGE CREDIT INSTITUTIONS OF BALI

6.1 INTRODUCTION

As discussed in Chapter 2, there are many studies in the literature that discuss the influence of institutions - both formal and informal institutions - on the performance and sustainability of economic/business entities or firms. The evidence strongly suggests that the success and sustainability of firms, including microfinance institutions, has been very much influenced by their institutional – both formal and informal institutions – environments. This chapter seeks to reveal the influence of informal and formal institutions and their interrelationship on the practical operational/institutional arrangements and the development of the Village Credit Institutions of Bali (Lembaga Perkreditan Desa or LPD) by using descriptive (qualitative) analysis. It starts with the history and development of the LPD, covering the reasons for its establishment and the legislation underlying it, as well as the objectives of the LPDs. The following section describes the supervision and guidance system of the LPDs which involves organizations such as the provincial government, the district government, and Bank BPD Bali. The practical and institutional arrangement of the LPD and the influence of the informal and formal institutions on the arrangement are discussed in the subsequent section, where particular attention is paid to how the institutional arrangements impact on the organization of LPDs, its recruitment system, its service delivery mechanism, and its remuneration system. The last section of this chapter presents some concluding remarks.

As described in Chapter 5, this study employs methodological triangulation - both quantitative and qualitative methods of data collection and analysis are used - in assessing the factors affecting the performance and sustainability of the LPD. The data used in this chapter are mainly from interviews with stakeholders of the LPDs such as the Chairpersons of LPDs, Board of Commissioner members, government officials, officials of Bank BPD Bali, and the clients of LPDs. In addition, unpublished documents from Bank BPD Bali and the provincial government of Bali - such as the history of LPDs, system and procedure of LPDs, and all regulations related to LPDs - are also used in this chapter.

6.2 THE DEVELOPMENT OF LEMBAGA PERKREDITAN DESA

In February 1984 the Ministry of Home Affairs of the Republic of Indonesia presented a seminar on *Rural Credit* in Semarang (Central Java) which dealt with several studies on local financial institutions in Indonesia (Bank BPD Bali 1986). Ida Bagus Mantra, the Governor of Bali at that time, sent his staff to attend the seminar in an effort to explore and harness the role of rural financial institutions in rural economic development. Based on the results of the seminar, the provincial government of Bali started to establish rural financial institutions in Bali, the so-called *Lembaga Perkreditan Desa* (Village Credit Institutions) or LPD. The first LPD, as a pilot project, was established in 1984 and many more followed in the following years, as shown in Table 6.1.

The objectives of establishing an LPD in each custom village (*desa adat*), according to the explanation of the Regulation No.2/1988 and No. 8 of 2002 on Village Credit Institutions (LPD), are to support rural economic development through enhancing the savings behaviour of rural people and providing credit for small-scale enterprise, to eliminate exploitative forms of credit relations, to create an equal opportunity for business activities at the village level, and to increase the degree of monetisation in rural areas (Government of Bali 1988; Government of Bali 2002). These objectives

reflect the development mission of the LPDs to provide financial services for rural people in Bali. Therefore, in assessing the performance and sustainability of LPDs, the achievement of these objectives is one of the important factors that have to be taken into account. The analysis of this matter is presented in the next chapter.

Table 6.1 Selected Indicators of LPD Development

Indicators	1988	1995	2000
1. Number of LPDs	157	848	926
2. Total Assets (billion Rp)	2.9	97	500.7
3. Savings & deposits (billion Rp)	1.8	70.4	392.7
4. Loans outstanding (billion Rp)	2.5	74.6	355
5. Loan to Deposit Ratio (LDR)	1.4	1.05	0.9
6. Equity & reserves (billion Rp)	0.5	16.25	64.9
7. Number of clients	n.a	580,707	895,512
8. Current profits (billion Rp)	0.34	7.78	36.6
9. Bank deposits (billion Rp)	0.91	17.05	122.2
10. Total employees	n.a.	3,532	4,533

Source: Bank BPD Bali, financial reports of 1988, 1995, and 2000
(all data in Rp is based on current price)

Since the first establishment, LPDs have been growing rapidly. The government of Bali province plans to set up one LPD in each of the 1,600 custom villages (*desa adat*). According to data from the Bank BPD Bali after the Provincial Government had targeted the establishment of one LPD in each custom village the number of operational LPDs increased from 157 in 1988 to 848 in 1995 and to 926 in 2000, as shown in Table 6.1. The total assets experienced a growth from Rp2.9 billion in 1988 to Rp97 billion 1995 and to Rp500.7 billion in 2000. This growth was mainly caused by the high growth of loans outstanding in that period. As known, loans outstanding in microfinance institutions are classified as assets (Ledgerwood 1999, p. 233). In addition, establishment of new LPDs also increased the total assets in that period. Savings increased from Rp1.8 billion in 1988 to Rp70.4 billion in 1995 and to Rp392.7 billion in 2000. Loans outstanding increased from Rp2.5 billion in 1988 to Rp74.6 billion in 1995 and to Rp355 billion in 2000. In 2000, 926 LPD served some 895,512 clients (from a total population of 3.054 million on Bali), which implies that one in every seven households was reached by an LPD, a degree of outreach which Bank-

Indonesia and GTZ consider to be unrivalled in Indonesia (Bank Indonesia and GTZ 2000, p.24). A detailed analysis of the outreach and these financial indicators will be discussed in Chapter 7.

Table 6.2 Distribution of LPDs in Bali by District, 1998 and 2000

City/District	1998	2000	Δ increase
1. City of Denpasar	31	31	0
2. Badung	71	81	10
3. Buleleng	125	126	1
4. Tabanan	171	171	0
5. Gianyar	141	151	10
6. Klungkung	77	78	1
7. Jembrana	55	55	0
8. Bangli	107	107	0
9. Karangasem	126	126	0
Total	904	926	22

Source: Bank BPD Bali (2000)

Table 6.2 shows the distribution of LPDs by city/districts in 1998 and 2000. In that period, only Badung and Gianyar districts experienced a significant increase of new LPD establishments. Referring to the establishment requirement of LPD mentioned earlier, the increases of LPD establishment in the two districts indicate the presence of custom villages with written custom regulations (*awig-awig*) and good socio-economic potential in the districts.

There are four interrelated factors explaining the remarkable growth of LPDs as financial intermediaries in Bali province. First, the rapid growth of the LPDs implies that the Bali provincial government has a strong political will to provide credit access for its people through establishment of the LPDs. This political will has been implemented in the provision of starting capital for the LPDs and creation of formal regulations that support and suit the LPDs, including the Provincial Regulation No. 6/1986 on the Status, Function, and Role of Custom Village and the Provincial Regulation No.8/2002 on the Village Credit Institutions. These two regulations are rooted in the custom and social norms of the Balinese people. Therefore, it can be

argued that these two provincial regulations (formal institutions) accompanied by custom village regulation or *awig-awig* (informal institution) in each custom village are important factors in fostering the growth of the LPDs. This conforms to the view, as cited earlier, that a combination of formal and informal institutions is an effective means of enhancing the success and sustainability of local institutions (World Bank 2002, p.178), such as the LPDs.

Second, the rapid growth of the clients and loan portfolio of the LPDs indicates that LPDs are suited to and meet the needs of Balinese people, especially in rural areas. As Christen *et al* (1995) argue, the rapid growth of the clients and loan portfolio of microfinance institutions is evidence of strong client demand. Referring to the Provincial Regulation No.8/2002, the LPDs are owned and operated by the community – the so-called custom village – with a shared set of informal institutions such as social and religious norms, as discussed in Chapter 4. Thus, the regulation and the LPD itself have incorporated elements of informal institutions. As a result, this ownership scheme has been a significant factor affecting the emergence of a sense of belonging (or clients loyalty) of the community members in the LPD (Bank BPD Bali 1986, p.5). In the development of a microfinance institution, enhancing such client loyalty is the primary driver of long-term financial success (Churchill 2000, p.19). This loyalty, for instance, is reflected by support and involvement of the custom village and its leaders in the development of LPDs. A provincial government officer interviewed for this study points out that one of the key success factors of the LPDs in Bali is the support from *Bendesa Adat* or the custom village leader (Narya, interview on 6 February 2002).

Third, because each LPD operates only in a custom village which is a relatively small area, the community member has adequate information about, and easy access to, the LPD. These factors most likely have influenced their confidence in the LPD. The credit and savings procedures (delivery mechanism) could be another factor responsible for the rapid growth of the clients of the LPDs. Concerning the delivery mechanism the LPDs have been applying a simple and flexible procedures such as no collateral for credit less than Rp500,000 and the use of mobile banking techniques for collecting

savings which means the LPD staff visits the clients door-to-door during week days (Bank BPD Bali 1999a). Some clients interviewed point out that the delivery mechanism is suited to their needs in terms of a simple and easy procedure, fast disbursement, and flexibility of loan repayment (Rempun, Kelin, and Warsha, interviews on 22 and 23 February 2002).

Fourth, the savings figures show that the LPD has not been just a lending institution but also a savings institution. It means that the LPDs have been able to act as an intermediary financial institution as well as a commercial bank. This is indicated by a decreasing of loan-to-deposit ratio (LDR) from 1.4 in 1988, to 1.05 in 1995, and to 0.9 in 2000, which means that the value of savings tends to exceed the value of credit outstanding. This phenomenon implies firstly, that the clients' confidence in the LPDs has been high, since the savings security is an important consideration for the clients in making a decision to save or not to save in any financial institution. This confidence emerges as a result of these financial institutions being owned, managed, and used by members of the custom village. As discussed above, by nature the clients of the LPDs are well-informed about the LPDs. Second, this situation implies that the LPDs have offered an appropriate system in mobilising savings such as mobile banking system, interest rates, and other incentives for savers and potential savers.

Lastly, the relatively stable economic condition in Bali since the 1980s has fostered the development of the LPDs. Microfinance institutions cannot be expected to operate sustainably in countries suffering from hyperinflation (Franks 2000, p.75; Robinson 2001, p.256). As discussed in Chapter 4, since the early 1970s, Bali has experienced a relatively stable and high economic growth (especially in tourism related sectors such as the trade, hotels, and restaurants sector), accompanied by stable macroeconomic performance (inflation rates have been relatively low). As a result, numerous profitable opportunities for investment have emerged. The growth of small-scale industries, in particular the handicrafts industries, was affected by the growth of the tourism related sectors, as has been discussed in Chapter 4. Permeating the whole economy of Bali,

this growing sector has resulted in high and growing demands for financial services, included LPDs.

6.3 THE LEGISLATIONS OF LEMBAGA PERKREDITAN DESA

Initially the establishment of LPDs was decreed by the Governor in 1984 (Government of Bali 1984) and subsequently reinforced by the Bali Provincial Regulation No. 2 of 1988 (Government of Bali 1988). Regulation No. 2 was later replaced by the Bali Provincial Regulation No. 8 of 2002 (Government of Bali 2002). According to the preamble of this regulation, the replacement was conducted in order to incorporate in the LPDs the changes in socio-economic environment in the last decade and to render them more flexible for future changes. However, basically, in regard to the establishment requirement, status and ownership, functions, objectives, organisation, and supervision and guidance remain the same. The discussion below refers to Regulation No. 8 unless otherwise indicated.

According to Regulation No. 8, the establishment requirements of LPD are that a custom village (*desa adat*) possesses a written customary regulation (*awig-awig*) and has the socio-economic potential to develop (Government of Bali 2002, article 5). This requirement indicates that the Regulations (formal institution) made by the provincial government of Bali have paid attention to and accommodated the informal institutions (including social custom, values, and norms within the customary law), which is the key factor for effectiveness of a formal regulation in delivering desired outcomes (World Bank 2002, p.172). The elucidations of the regulation clearly states and recognises that the customary law is more likely to be obeyed by the members (*krama desa*) of *desa adat* (custom village) than any government regulations, since the social custom, values, and norms have existed for centuries.

The accommodation of the informal institutions in the formal institutions is also reflected in the elucidation of the Bali Provincial Regulation No. 2/1988 on Village Credit Institutions. The elucidation points out that the regulation was legislated in order to maintain and improve the existence and independence of *desa adat* (Government of

Bali 1988). Moreover, the elucidation points out that the LPDs are community financial institutions that are owned, managed and used by the members of the custom village. This Regulation states that the operational arrangement of LPD has to be based on Balinese custom. This indicates that, even though the LPD is initiated from 'outside' (the Provincial Government), it is based on local needs and directed towards the development of a decentralized and customer-owned financial system. The requirement for a custom village to have a written custom village regulation, as mentioned above, implies that the LPD seeks to draw upon the rules, behavioural norms and code of conduct for the community of a custom village (Oka 1999; Government of Bali 2002, Article 5). This in turn strengthens the competitive advantage of the LPD among other competitors such as Koperasi Unit Desa (Village Unit Cooperative) and BRI Village Unit.

Finally, the recognition and adoptation of informal institutions in the Regulation No.8/2002 is also evident in the requirement that the daily operational activities of LPDs have to be accountable to the custom village through its leader (*Bendesa Adat*), and that the core management team has to be recruited and selected from the community members (*krama desa*) of the village and elected during village meetings (*paruman desa*).

In addition to possession of a written custom village regulation requirement, the establishment also depends on the annual provincial government budget for providing starting capital and preparing staff management (Bank BPD Bali 1986). In the establishment of a new LPD, the Provincial Government of Bali provides starting capital of Rp10 million[50] and establishes special supervision and guidance teams at all government levels, which cooperate with the Regional Development Bank of Bali

[50] Prior to Regulation No. 8, starting capital provided by the Bali Provincial Government was Rp2 million and it had to be repaid within 5 to 10 years, based on the Bali Governor's Decree No.972/1984. This is called a subsidy without dependence (Chaves and Gonzales-Vega, 1996, p.73). The subsidy was on one-time loans and was not followed by the expectation of additional injections of resources. This kind of subsidy is still valid in the new regulation. No operating subsidies were granted. Chaves and Gonzales-Vega argue that the advantage of this approach is that the organisation has to be able to plan on a solid basis, rather than depend on annual budgets outside resources and become vulnerable to the swings associated with such funding, linked either to the mood of politicians or the availability of fiscal resources in a particular year.

(Bank BPD Bali). Bank BPD Bali is a provincial government-owned bank which is appointed, through the Governors Decree No. 344 of 1993, to give technical guidance to the LPDs. The function of each organisation involved in guiding and supervising the LPDs, including Bank BPD Bali, is discussed in the next section.

6.4 SUPERVISION AND GUIDANCE SYSTEM OF THE LPD

As noted earlier, the LPD is different from other provincial government controlled institutions such as the *Badan Kredit Kecamatan*/BKK (Sub-district Credit Board) in Central Java or *Kredit Usaha Rakyat Kecil*/KURK (Small Enterprise Credit Institutions) in East Java because its ownership and organization are influenced by Balinese social custom. Article 11 of the Provincial Regulation No. 8 states that the LPD is managed and operated by a committee elected by community members of the custom village (Government of Bali 2002). Along with the other regulations mentioned above, this indicates a close relationship between LPD and the custom village which can be expected to be a significant factor in holding these microfinance institutions together (Oka 1999, p.14-15).

In respect to supervision and guidance, the Provincial Regulation No.8/2002 and the Governor's Decree No.3/2003 state that there are three groups of organisation involved in giving supervision and guidance for the LPDs both at provincial and district level (Figure 6.1). They are the local government (Governor and Mayor Office), Bank BPD Bali (Head and Branch Office), and the LPD organisations (*Pembina Lembaga Perkreditan Desa Propinsi* or PLPDP is provincial supervision organisation; and *Pembina Lembaga Perkreditan Desa Kabupaten/Kota* or PLPDK is a district supervision organisation). In practice, the involvement of the three groups of organisations in supervision and guidance does not cause overlapping or colliding, since the job description of each organisation is explicit and distinctive, as will be explained below.

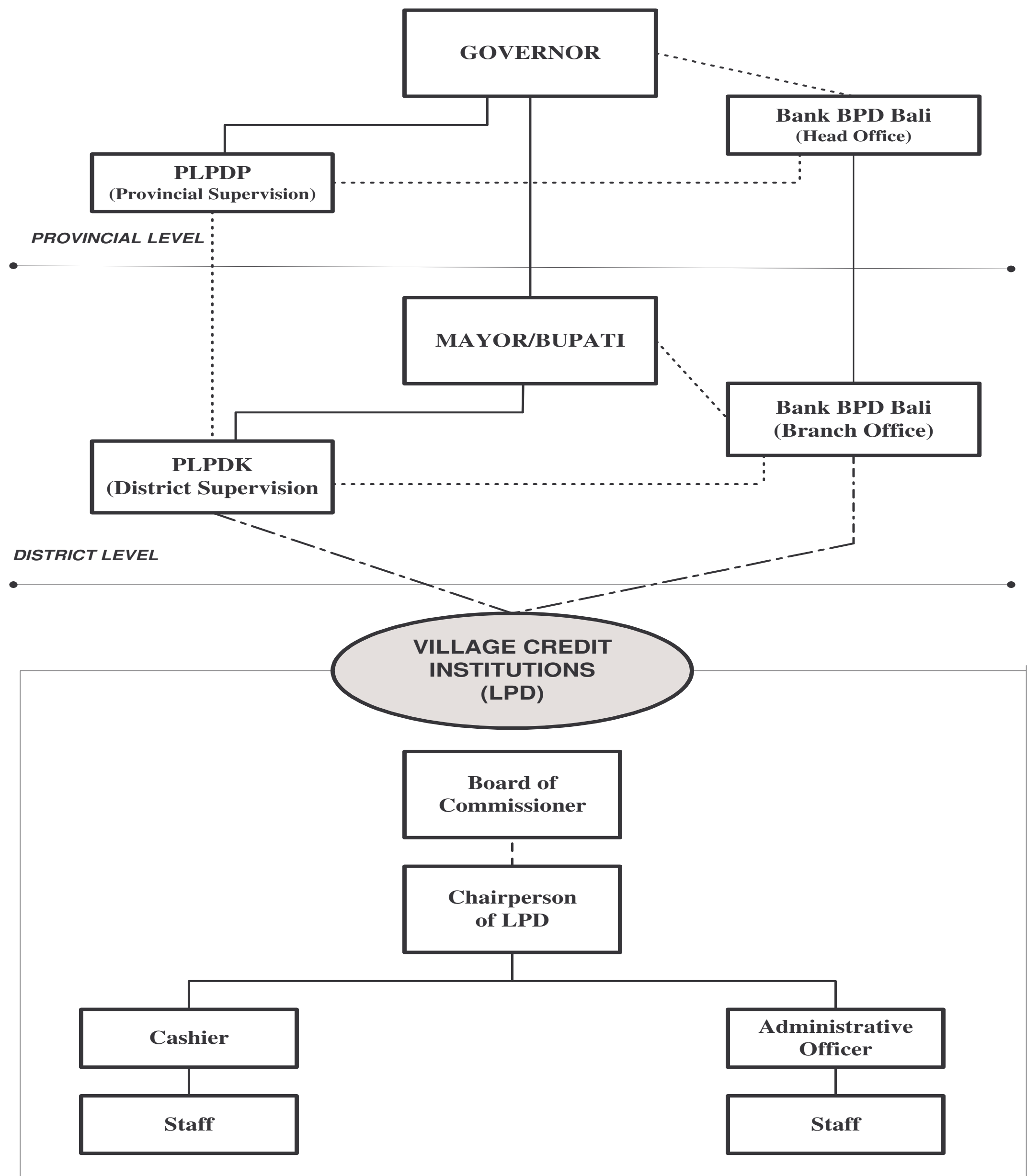
The functions of the provincial government are outlined in the Governor's Decree No. 401/1997. Article 2 of the Decree states that the functions of provincial and district governments are: (1) conducting guidance, supervision, and control in supporting the development of the LPDs; and (2) conducting an evaluation and development report of the LPDs as the material basis for further supervision (Government of Bali 1997). The provincial and district governments are not involved in the day-to-day running of the LPDs. These functions imply that the role of the Provincial and Districts Government of Bali has been at the appropriate level in fostering and supporting the development of LPDs.

Referring to the theory of institutional development, there are three levels of intervention from 'outside' organisations - in this case the Bali provincial government - in local organisations (Uphoff 1986, p.188-9). When the local institutions are strong and possess community linkages, which is the case of Bali which has a strong role of custom village (*desa adat*) in Balinese daily life as discussed in Chapter 4, outside intervention may take the mode of assistance. Applying this theory in microfinance institution development, Snow (1999) points out that for this assistance mode, the impetus for intervention may come from the bottom up and simply require some outside technical expertise, or resources, to help locals do what they wish to do. When the local institutions are weak, outside intervention may take the form of promotion. The promotion mode happens, for example, when local government has to convince the local leaders to utilise microfinance institutions to accomplish their goals (Snow 1999). In between the two levels is a facilitation level where local interest is supplemented by help in developing program models and finding clientele. In Bali the local institutions are the custom villages whose custom regulations play a dominant role in society as mentioned earlier. Hence, referring to the theory and the strong local institutions, it could be argued that in the development of the LPDs, the Provincial Government of Bali has applied an assistance mode through provision of a legal basis for the LPD and general supervision and guidance.

According to Regulation No.8/2002, supervision and organisation at provincial level is *Pembina Lembaga Perkreditan Desa Provinsi* (PLPDP) and supervision organisation at district level is *Pembina Lembaga Perkreditan Desa Kota/Kabupaten* (PLPDK). Article 1 of the Regulation states that the function of PLPDP is limited only to coordinate the PLPDK activities, while the functions of PLPDK are more complex. As stated in Article 2 of the Governors' Decree No.3/2003 (Government of Bali 2003), the PLPDK has to monitor the condition of the LPDs and conduct technical guidance, institutional development and training for the staff of the LPDs in its operational area. The PLPDK also has to calculate and recapitulate the profit of all LPDs in a district and deposit the supervision funds with the Governor, Mayor/Bupati, and Bank BPD Bali monthly. In addition, the PLPDK has to provide a development report and the healthiness rating of all LPDs for the Mayor/Bupati and Bank BPD Branch Office monthly.

The Governor's Decree No.344/1993 also identifies the function of Bank BPD Bali. Stated in Article 2 of the Decree (Government of Bali 1993b), Bank BPD Bali has three functions in respect to the LPDs. First, to conduct technical guidance in two ways, namely through passive guidance, referring to conducting the financial reports analysis of each LPD, and active guidance, referring to conducting direct visits to the LPD site. Two officers of Bank BPD Bali interviewed for this research mention that the active guidance and supervision are conducted frequently in the case of LPDs facing a crucial problem, such as too many credit defaults or low repayment rates (Warsana and Wiweka, interviews on 7 February 2002 and 21 February 2003). Second, Bank BPD Bali has the task of managing the coordination with the other organisations related to the guidance and supervision of the LPDs. Third, it must provide a quarterly evaluation report on the financial performance and the healthiness of the LPDs to the Governor. In conducting its functions, according to these two officers, Bank BPD Bali has not faced any significant difficulties because the Bank staff have been well trained and because good coordination and cooperation exists between the government and the LPD management.

Figure 6.1 LPD Organisation and Supervision



Command line

Coordination line

Supervision line

Guidance line

Source: diagram by author based on the Bali Provincial Regulation No.8/2002

Further, in practice the role of Bank BPD Bali in the development of LPDs lies not only in giving technical guidance but also in acting as the 'banker' for LPDs. According to Article 7(d) of the Provincial Regulation No.8/2002, LPDs have to deposit their excess liquidity to Bank BPD Bali and receive a competitive interest rate. There is no record of LPDs violating this rule (Bank BPD Bali 2000, p.4). According to the data from Bank BPD Bali (2000), the value of the deposit – that consists of savings and term deposits - has increased over time and reached Rp131.4 billion in 2000. This large sum indicates that the LPDs make a significant contribution to the Bank BPD Bali. One of two officers of the Bank BPD Bali interviewed mentioned that about sixty percent of savings and term deposits in Bank BPD Bali are from the LPDs (Warsana, interview on 7 February 2002). This relationship results in benefits for each institution. LPD can use its excess liquidity in a secure and productive way and receive an interest income, while at the same time ruling out the possibility of LPDs giving credit to the non-community members of the custom village. As is known, according to the Regulation, giving credit to non-community members is not allowed since they are not tied to the corresponding custom village regulation. This principle of loan delivery will be discussed in section 6.5. Meanwhile, Bank BPD Bali is able to use the LPDs deposit as loanable funds to its clients (Bank BPD Bali 2000, p.5).

6.5 THE MANAGEMENT OF LPD

Organisation and planning

The organisation of LPD is uncomplicated. Based on the Bali Provincial Regulation No.8/2002, each LPD is managed by a committee (core management) that consists of a chairperson, cashier and administrative officer (Figure 6.1). The LPD organisation and supervision chart shown in Figure 6.1 is based on the Regulation. The job descriptions of the core management are described as follows (Djaya 1999, p.19-20). The tasks of the chairperson include coordinating daily operational activities of the LPD, conducting contractual agreements with clients, being accountable to the custom village through its leader (*Bendesa Adat*), crafting action and budget plans, and formulating the LPD

policies including saving, credit, and the direction of development policies of the LPD. The administrative officer has a set of tasks which include conducting administration tasks, both general administration and book-keeping, being accountable to the LPD Chairperson, conducting the Balance Statement and Income Statement, and managing archives. The tasks of the cashier are to record the flow of funds such as savings, term deposits, loans, and being accountable to the LPD Chairperson.

As a result of the simple organisation, according to the Chairperson of LPD Mas, the span of control is not wide; the responsibility of each unit in the LPD is clear, well-distributed, and easy to monitor (Ardana, interviews on 21 and 23 February 2003). This enables the Chairperson to manage, coordinate, and control each unit of activities including savings, term deposit, and credit unit in the LPD Mas. The LPD staffs assist the Chairperson in his tasks and are involved in creating the activity and budget plan and in credit decisions. The creation of the activities and budget plan is initially from a plan of each unit of activities and then processed and unified by the core management to be an activity and budget plan for the whole LPD. Therefore, all staff know the plan and its objectives. The plan then has to be approved by *Bendesa Adat* (The Chief of Commissioner Board of LPD). In addition, the LPD management also write an annual financial report which is submitted to *Bendesa Adat*, *Kepala Desa* (the administrative village leader), *Camat* (the sub-district leader), and PLPDK (district supervision organisation). According to the Chairperson interviewed, the credit unit in the LPD is relatively more complicated than the saving and term deposit units, since the former sometime faces some problems such as clients who apply for a credit which exceeds the permitted limit for the client, and or delinquent borrowers.

In managing LPD Mas which is located in the handicraft based sub-district, the management team also monitors the changes in the macroeconomic situation - such as economic growth that influences market demand for products, interest rate, and inflation rate - which often influences the business of its clients, especially artisans/craftsmen and handicraft entrepreneurs (Ardana, interviews on 21 and 23 February 2003). Internal evaluation of the LPD Mas is conducted by the Commissioner

Board. In addition, the LPD management also conducts a quarterly formal meeting for internal evaluation that involve all staff. Collector staff (credit or savings) are given a daily briefing on their duties by the Chairperson of LPD Mas before they start work, for example, how to collect instalments and savings from the clients who will be visited on that day.

The information gained from the interview with the Chairperson of LPD Mas thus suggests that the planning and organising process in this LPD functions well, and that no problems have confronted the LPD management which it has been unable to resolve by itself. This conforms to the Chairperson's argument that the organisation structure of LPD Mas is still capable of implementing the LPD policy and strategy to achieve its objectives. The internal management capability of the LPD Mas is supported by the supervision and guidance offered by local government at all levels and by Bank BPD Bali. The next section deals with the recruitment procedure of staff of LPDs. The discussion on this matter is important in order to know who and how the staff are to be recruited.

Recruitment procedure

The core management team is recruited from the local custom village (*desa adat*). They are selected from the community members (*krama desa*) of the village and elected during village meetings (*paruman desa*) for a four-year period, but they could be re-elected if they performed well in managing the LPD (Government of Bali 2002, Article 11). The management committee is usually assisted by two or three staff responsible for the collection of savings and loans (loan and saving collectors).

One of the important tasks of the core committee, according to Article 11(4) of the Bali Provincial Regulation No.8/2002, is an authority to appoint new staff or to discharge staff in operational management of LPD. Two Chairpersons of LPDs interviewed point out that the recruitment of the additional staff is based on the business size of the LPDs (Ardana and Kurniawan, interviews on 21 February 2002 and 23 February 2003). This recruitment has to be approved by the Chief of LPD Commissioner Board who is the

custom village leader (*Bendesa Adat*). The two Chairpersons also point out that the selection of the new staff by the Board of Commissioner is also based on the aptitude and an attitude test (character-based) of the applicants.

In the case of LPD Mas, an additional recruitment criterion is that each of the eight *banjar* (hamlet) in the Mas custom village must be represented among staff members. This criterion suggests that the LPD wants to maintain close relations with all *banjar* of the *desa adat* (custom village) and possibly to have a staff member who personally knows the client and thus can evaluate the client's creditworthiness. This staff selection process is conducted by the *Bendesa Adat*. After passing this selection process, the applicant has to attend an aptitude test conducted by PLPDK. This test includes motivation, willingness to serve the LPD, and general knowledge. The general requirement of the applicant is to hold at least a high school certificate level. The two Chairpersons of LPDs interviewed also point out that this recruitment process is applicable for all LPDs.

As there is no initial training period, the successful applicant then begins to train on the job. The position and area expertise of the staff are not fixed, and once a year, a work rotation will take place which aims at mastering every unit of activities. However, after several months on the job the staff receives some additional training, funded and conducted by the LPD Mas in cooperation with Bank BPD Bali.[51]

In sum, this recruitment procedure reflects the role of informal institutions on the management (practical arrangement) of LPDs. It is also shows the embeddedness of the LPDs with the socio-cultural environment. In particular, the recruitment procedure reflects the LPDs rootedness in their socio-cultural environment.

[51] The Chairperson did not mention exactly how many months.

Principle of operational arrangement

In regard to the practical operational arrangement of the LPDs, the elucidation of the Provincial Regulation No.8 states that the LPDs have to apply the prudential principle of financial institutions for achieving healthy financial institutions. However, this regulation only states the principle in general terms. The principle includes the regulation on capital adequacy, legal lending limit, reserves for loan losses, liquidity management, and rating system of LPD. Another government regulation is the BPR CAMEL rating criteria imposed by the Bank Indonesia (the Central Bank) based on Circular Letter No.30/UPPB, 30 April 1997 (Bank BPD Bali 2000, p.15). This regulation is basically the same as the prudential principle imposed by the Provincial Regulation, but it is more elaborated. This regulation sets the criteria of the capital adequacy ratio (CAR), productive asset quality, management aspect, earnings, and liquidity.[52] Based on the CAMEL criteria, Bank BPD Bali (2000) classifies LPDs into four categories: sound, fairly sound, less sound, and unsound. According to Bank BPD Bali (2000), 787 of 926 LPDs, or 85 percent, were classified as sound and fairly-sound (Bank BPD Bali 2000, p.15).

Delivery mechanism

The above description of the LPD's organisational structure and recruitment procedure reveals a strong relationship between each LPD and its community. This strength lies in the fact that the LPD is an institutional element of the custom village (*desa adat*) and is not related, as discussed in Chapter 4, to the administrative village (*desa dinas*). Therefore, as local and user-owned financial institutions, the LPDs have an intimate knowledge of their clients and rely on mechanisms of social control in screening and enforcement problems that are based in the shared social and religious norms of the custom village (Oka 1999). As a result, client information is easily available which could eliminate the asymmetric information mentioned in Chapter 2 as a key problem that affects the likelihood of default of microfinance institution. This is one of the comparative advantages of the LPD compared with other microfinance institutions in

[52] The calculation method of the CAMEL criteria is presented in Appendix 2

Indonesia. Warren (1993) argues that the character of the custom village as a democratic system regulated by customary law provides strong socio-cultural bonds and effective control for LPD operations.

The strong influence of the custom village (including the shared social and religious norms) is reflected in its operational arrangement as is clearly shown in the credit mechanism or loan processing. The first step in loan processing is that a loan applicant has to fill out a simple loan application form which establishes the profile of the applicant (Bank BPD Bali 1999a). Then the applicant goes to the Chairperson of LPD Commissioner Board (*Bendesa Adat*) to ask for a reference. As pointed out by most interviewees,[53] the decision of the *Bendesa Adat* is mainly based on the character of the applicant. When the character (reputation) of the applicant meets the requirements, the *Bendesa Adat* gives the applicant a reference and then the applicant goes to the LPD to ask for the loan. At the LPD level, the LPD management evaluates the capacity and prospect of the applicant's business (Bank BPD Bali 1999a, p.7). Three Chairpersons of LPDs interviewed point out that the time between submitting an application and disbursement of the loan ranges between one day and one week for first time borrowers; however, only one day is required for a repeat borrower (Ardana and Kurniawan, interviews on 21/22 February 2002, 22/23/25/26 February 2003). As discussed in Chapter 2, this mechanism is called character-based lending approach.

This advantageous and cheap technique (Chaves and Gonzales-Vega 1996), accompanied by local monitoring, has been comparatively efficient in avoiding costly mistakes in assessing the probability of loan repayment and, in turn, also lowers the transaction costs (Timberg and Aiyar 1984; Onchan 1992 ; Yaron 1992; Chaves and Gonzales-Vega 1996). According to Bank BPD Bali (2000), the loans portfolio of the LPD is classified into four categories: pass, doubtful, sub-standard, and loss. Based on this criteria, in 2000 the repayment rate[54] of all the LPDs in Bali based on their

[53] The list of interviewees is presented in Appendix 3.

[54] Repayment rate is the ratio between the first three categories of outstanding loans divided by total outstanding loans (all four categories).

consolidated balance statement was 92.34 percent (Bank BPD Bali 2000). This rate was higher than the repayment rate of BKK which was only 80 percent (Yaron, Benjamin et al. 1998).

The flexible procedure in delivery mechanism is also reflected in the types of loans and the loans repayment patterns. The three Chairpersons of LPDs interviewed mention that LPDs offer weekly, monthly and seasonal credit schemes with maturities of between 3 and 12 months, but most credit must be repaid within a month. Regarding the loans repayment patterns, they point out that the patterns could be adjusted to a wide variety of activities financed and their typical cash flow patterns, for instance, small-scale industry entrepreneurs, small traders, and farmers. Even though the standard loans predominated - LPD generally collects repayments weekly and monthly - the LPD has permitted balloon repayments and even daily repayment schedules when justified.

Concerning the interest rate, in 2002 the lending interest rates for loans ranged from 27 percent to 33 percent which is higher than the average commercial bank interest rate of 22 per cent per annum. This relatively high lending interest rate has allowed the LPDs to cover their operational costs and loan losses. In determining this interest rate, the LPDs consider the interest rate offered by Rural Credit Bank (BPR) and the assumption that the poor are willing to pay for access and convenience. Even though the LPDs offer a relatively high lending interest rate, they also offer some advantages to their clients, such as simpler and easier procedure, low transaction costs, faster disbursement, and sometimes collateral free (for small amount of loans of less than Rp500 thousand). Moreover, the impressive growth of loans outstanding as shown in Table 6.1 implies that this relatively high interest rate is still affordable and profitable for the businesses of the clients The three Chairpersons interviewed argue that through its relatively small loan amounts, flexible repayment patterns, relatively quick loan disbursement, and delivery mechanisms tailored to client needs, the LPD services have succeeded in alleviating the problem posed by usurers (money lenders) in the rural area.

Another important aspect of the credit mechanism is the principle of loan delivery. The principle of the loan delivery in LPD is that a loan only be given to clients on an individual basis who are the members of the custom village (*desa adat*) where the LPD located (Government of Bali 2002, Article 7(1.b)). As noted earlier, according to the regulation, an LPD located in a certain custom village is not allowed to give credit to the people who live in other custom villages. However, in practice some large LPDs in urban and semi urban areas also serve non-community members to which their custom village regulations (*awig-awig*) do not apply (Bank Indonesia and GTZ 2000).[55] This practice could become a severe problem faced by the LPD in enforcing contractual agreement – for instance, in enforcing the repayment of the clients - between the LPD and its clients. The Chairperson of an LPD interviewed also states that the LPD also gives credit to the non-community members of its custom village since the LPD experiences an excess liquidity (Ardana, interview on 21/22 February 2002). But the arrangement was conducted through the coordination with, and the involvement of, the *banjar* (*hamlet*) and not on an individual basis.

Concerning the principle of loan delivery, a provincial government officer interviewed argues that this is a challenge that many LPDs will face in the future, when their business size and credit transactions grow and the socio-cultural aspect of clients is more diverse (Windusara, interview on 6 February 2002). In this situation, a client – who is not a community member or non-native Balinese – could violate the custom village regulation because he/she is not tied by the social norms and this, in turn, would result in eroding the effectiveness of any sanctions (such as exclusion from the community) that could be imposed by the LPD. This conforms to the World Bank (2002) argument that informal institutions could become less effective as the number of trading partners of an institution grows and they become more socio-culturally diverse (World Bank 2002, p.172). Dealing with this potential problem, the cooperation among LPDs on one side and custom villages on other side (Windusara, interview 6 February 2002), and the existence of formal institutions supplanting community norms as the

[55] The custom village regulations, in general, do not differ much from village to village, but a custom village regulation in one village does not apply to other villages.

World Bank suggests (World Bank 2002, p.177) are needed to prevent or overcome such a problem in the future, since the changes in the number of credit transactions and a more diverse socio-cultural aspect are inevitable as results from socio-economic development.

As mentioned earlier, one of the objectives of the LPD establishment in each custom village is to support rural economic development through enhancing the savings behaviour of rural people (Government of Bali 2002, Article 7(1)). Other than this, this savings product is also expected to ensure financial discipline and to build a positive relationship between the LPDs and its clients which, in turn, will maintain good repayment rates of its clients. In addition, promoting savings facilities is essential for rural development since they encourage the rural population to store value in an efficient way and, in turn, increase domestic savings (Yaron 1994, p.61). Further, Yaron (1994) also points out that a microfinance institution success in mobilising savings is one of the key factors for its self-sustainability.

As well as the lending rates, savings interest rates also vary from one LPD to another since each LPD is allowed to set up the rate independently. However, in general the interest rate is not much different among LPDs in the same sub-district since they use the same basis for interest rate determination. One Chairperson of an LPD mentioned that the basis for interest rate determination is the interest rate of competitors, that is, the BPR (People's Credit Bank) and the BRI Unit Desa located in the same sub-district (Ardana, interview on 23 February 2003). In 2002, the LPDs offered around 0.8 percent per month for savings and 1.3 percent per month for term deposits. The interest rate of term deposits was slightly higher than those offered by the BPR at 1.1-1.2 percent per month. The Chairperson argued that the slightly higher interest rate is aimed to make the LPD more competitive than the BPR (People's Credit Bank).

Most clients' savings in LPDs is collected through mobile services. A LPD staff member visits the clients each day of the week, often on market day, collecting savings deposits and loan repayments. In some cases, in the literature this practice has reduced

transactions costs for both the clients and the microfinance institutions (Yaron 1994, p.62). Moreover, this procedure could also be expected to increase the loan repayment rate through the increase of the financial disciplines of the clients.

The loan delivery process described above clearly shows that the LPD uses existing social structures in screening potential borrowers to ensure that the potential borrowers are selected appropriately and repayments are made on time. The use of the legitimate informal leader (*Bendesa Adat*)[56] in the custom village to help screen loan applicants has secured prompt loan collection. The LPD relies on the reputation, authority, and official and social status of the village leader (*Bendesa Adat*) to overcome one of the principal deficiencies of general banking: inadequate information on the creditworthiness of potential borrowers. This type of informal information is based on trust (World Bank 2002, p.173). The three Chairpersons of LPDs interviewed state that when the borrower shows a poor performance in his/her credit repayment, the penalty is immediate: additional borrowing is prohibited, and the borrower's access to credit is eliminated until he/she completely repay his/her loans. In contrast, they state that the borrowers who make timely repayments are gradually allowed to increase the amount of credit they are eligible to receive.

In relation to the custom village regulation as discussed in Chapter 4, social sanctions could be applied to the clients who violate the rules, for instance, by not repaying their credits properly (Oka 1999). The heaviest social sanction is the exclusion of the delinquent borrower from the community, which means that they lose their share of community ownership and the plot of land on which their family compound is built is withdrawn. They could also lose the right for a funeral in the village cemetery and subsequent cremation. He/she could become an outsider without the security of the community and must look for a new life far away from their native village. However, Oka (1999, p.19) suggests that the sanctions should be economic such as seizing physical assets, since the exclusion sanction is regarded as a severe sanction with many

[56] *Bendesa Adat* is the leader of the custom village who is elected in the village meeting (*paruman desa*) by the members of the custom village (*krama desa*) in a democratic way (Oka, 1999).

negative implications for the offender. According to the interviewees mentioned earlier and Oka (1999, p.17), the custom village regulation has been effective in overcoming the problem of delinquent borrowers or low repayment rates, which is the main cause of microfinance institutions failures (Yaron 1994; Christen, Rhyne et al. 1995; Woolcock 1999).

The custom village regulation also applies to the staff of the LPD (Oka 1999, p.18) who violate the regulation or mismanage daily operations of the LPD such as collusion, corruption, or manipulation. The social sanctions could also be imposed on them. Moreover, based on formal legal regulation, Article 24 of the Provincial Regulation No.8/2002 states that LPD staff who violate the regulation causing the LPD to suffer a financial loss have to compensate the loss. Article 26 that elaborates Article 24 of the regulation emphasises that convicted staff could be punished by a maximum 6 months in jail or a maximum fine of Rp5 million. In sum, this description indicates that informal institutions (such as social norms and sanctions) and formal institutions (a formal legal regulation) are used simultaneously in the practical arrangement of LPDs.

Remuneration system

The three Chairpersons of LPDs interviewed point out that the remuneration system of the LPD is generally intended to stimulate better performance of its staff, especially in collecting loans and promoting and servicing savings (Ardana, Kurniawan, and Cendikiawan, interviews on 21/22 February 2002 and 22/23/25/26 February 2003). However, the remuneration system of each LPD differs from one another since the salary, bonus, and other incentives are based on the cost of living in the village where the LPD is located and the financial capability (such as profit) of each LPD. The Chairperson of LPD Mas stated that his basic salary is based on the daily wage of a sculptor. The use of a sculptor's wage as a benchmark is based on the fact that the sculptor is the profession of many people in Mas village of Ubud, which is a handicraft-based village. If the wage of a sculptor is Rp50 thousand per day, the salary of the Chairperson per month is 30 times Rp50 thousand. Meanwhile, the Chairperson of LPD Kerta village interviewed - which is an agriculture village - stated that his basic

salary is based on the wage of daily worker in the village i.e. Rp30 thousand per day, hence his salary is 30 times Rp30 thousand per month. Among the core management of the LPD, the Chairperson earns the highest salary, followed by the cashier and administrative officer. This principle of basic salary determination that is based on the cost of living in the village where the LPD located also reflects a strong relationship between the LPD and its socio-economic environment. This strong relationship implies the embeddedness of LPDs with its socio-economic environment and, in turn, has strengthened the existence and sustainability of LPDs as a local firm or organisation. As argued by some scholars (Meyer and Rowan 1977; DiMaggio and Powell 1983; Esman and Uphoff 1984; Uphoff 1986; Baum and Oliver 1991; Carrol 1993; Oliver 1997; Snow 1999) the sustainability of a local firm or organisation depends on its ability to fit with and adopt to its socio-economic environment.

Although the basic salary determination differs from one LPD to another, there has been a general rule concerning the determination. According to the Gianyar Mayor's Decree 2002, the total amount of salary received by all management staff is a maximum 30 percent of net profit in each month. In addition to the basic salary, the Chairperson of LPD Mas states that each staff member of LPD Mas also receives some incentives, including pension insurance for cooperating with one insurance company (PT BAJ)[57] and some bonuses. Staff who will be pensioned are given between 4-16 months' separation pay depending on the length of their working experience. A bonus is given for certain purposes. One type of bonus is an end of year bonus or production reward which is 10 percent of the net profit of each LPD, as mentioned in the previous section. This bonus is aimed to enhance and stimulate the working spirit and productivity of the staff. The amount of bonus received by each staff member, however, varies since the bonus distribution not only depends on the type of job and but also the length of working experience of the staff. Another type of bonus is a collection fee (incentive payment) which is given to the loan collector monthly. This incentive is also aimed to increase the working spirit of the loan collector. The

[57] LPD Kerta in Payangan does not have an insurance program for its staff

Chairperson mentioned that the incentive payment amount is 0.05 percent of the total loan instalment per month.

The remuneration system discussed above reveals that the LPD has applied a system which is called in the literature a management compensation scheme based on performance (Chaves and Gonzales-Vega 1996, p.71). This system consists of a total remuneration that results from a combination of a fixed salary plus bonus or incentive payment that is a function of some observable and measurable variable, such as profits or loan instalments recovered. This scheme indicates that the remuneration system of each LPD is relatively fair and accountable. It is fair since the remuneration is based on performance and the responsibility of the staff (merit system) and it is accountable since it is based on certain observable and measurable variables. Further, the three Chairpersons also stated that they are satisfied with the salary, bonus, and other incentives they receive and they think they would not be able to get an equal job and payment. Referring to Chaves and Gonzales-Vega (1995), the statement implies that efficiency wages[58] are being paid. The satisfaction of the staff with the remuneration system of their LPD is also indicated by the working motivation of the staff. According to the Chairpersons interviewed, the high working motivation of their staff is reflected in the very low absence and turn over rates they have observed.

The stable and growing macroeconomic condition accompanied by the liberalisation of financial markets at the national level, political stability in Bali, support from government at all administrative levels, a high degree of social cohesion of the Balinese people, and the importance of traditional social structures have fostered the growth of LPDs. In sum, there is no doubt that the stable and growing macroeconomic and socio-cultural environments have been important factors in the growth and development of LPDs in Bali.

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[58] Efficiency wages refer to the salary paid to an employee while equivalent workers would be willing to perform exactly the same tasks for a lower wage (Chaves & Gonzales-Vega, 1996, p.72)

6.6 SUMMARY

Based on the above discussion, it can be concluded that the institutional environment of the LPDs has significant influences on their practical arrangements and, in turn, on the success of the LPDs in achieving theirs objectives in providing financial services for rural people as a financial intermediary.

The evidence of the direct influence of Balinese social custom including social values, norms, and sanctions (informal institutions) on the LPDs is indicated in their practical operational arrangement, including the organisation, recruitment procedure, delivery mechanism, and remuneration system. Along with the influence of informal institutions, the formal institutions have also had some direct influences on the practical operational arrangement of the LPDs. The influences are reflected in the supervision and guidance system of LPDs, an obligation to apply prudential principles of banking and the remuneration system.

Regarding the relationship between formal institutions and informal institutions, there is evidence that the local government regulations (formal institutions) concerning the LPDs have accommodated the informal institutions (including social custom, values, and norms) of the Balinese in the background of their establishment, status and ownership, and organisation of the LPDs. This is an important lesson from the LPDs' experience. The Government of Bali Province has properly supported the development of the LPDs by providing a formal legal basis and start-up capital. The support through the provision of the formal regulation as a legal basis - that is rooted to the social norms (informal institutions) of Balinese people - has strengthened the existence of LPDs. This is one of the key factors affecting the sustainability of a microfinance institutions since inadequate attention paid to norms and culture would result in less effective formal institutions to achieve desired outcomes (World Bank 2002, p.172).

Referring to the theory of institutional development, the intervention of the Provincial Government of Bali has been at the appropriate level in fostering and supporting the

development of LPDs. The Provincial Government of Bali has applied an assistance mode through provision of a legal basis for the LPDs and general supervision and guidance. According to the theory, when the local institutions are strong and possess community linkages – as is the case in Bali - outside intervention may take the mode of assistance.

Finally, the stable and growing macroeconomic condition in Bali since the 1980s until the present time has also fostered the development of LPDs in Bali. This auspicious economic condition, accompanied by the liberalisation of the financial market policy taken by the Indonesia government, has deepened the role of financial institutions, particularly the LPD, in Bali's economic development. This good economic condition and financial deepening, in turn, have stimulated the emergence of numerous profitable opportunities for investment in Bali. In sum, there is no doubt that the stable macroeconomic conditions have been an important factor in the growth and development of the LPD in Bali. As noted earlier, some scholars (Chaves and Gonzales-Vega 1996 ; Franks 2000, p.75; Robinson 2001, p.256) argue that socio-economic characteristics of an environment have been one of the most important factors of a successful of microfinance institution since microfinance institutions cannot be expected to operate and develop sustainably in regions suffering from hyperinflation and political instability.

After discussion on the role of institutions on the practical arrangements (management) of the LPDs in this chapter, the next chapter deals with the role of institutions on the financial performance of the LPDs.

CHAPTER SEVEN

PERFORMANCE ANALYSIS OF VILLAGE CREDIT INSTITUTIONS WITHIN GIANYAR DISTRICT IN BALI PROVINCE

7.1 INTRODUCTION

As noted earlier, this study employs methodological triangulation in which both quantitative and qualitative methods of data collection and analysis are used. In the previous chapter, qualitative (descriptive) analysis is used to assess the influences of institutions on the performance and sustainability of the Village Credit Institutions of Bali (Lembaga Perkreditan Desa or LPD). In this chapter, quantitative analysis – both non-parametric statistics and econometrics – is used to assess the same matter. Specifically, the aim of this chapter is twofold. First, it seeks to assess the performance indicators of the Village Credit Institutions (LPDs) of Gianyar district in Bali as a whole. Second, it will assess the influences of the different economic base of a region on the performance and sustainability of the LPDs by investigating whether or not there is any difference in performance between the LPDs located in sub-districts characterized by predominantly handicraft industries and the service sector and the LPDs located in sub-districts characterized predominantly by the agricultural sector. The analysis focuses on financial indicators and outreach. The financial indicators include portfolio quality, leverage, capital adequacy ratio, productivity, efficiency, profitability, and financial viability.[59] The outreach indicators cover clients and staff outreach, loan outreach and saving/deposits outreach. In the last part of the analysis, a logistic regression analysis is presented which assesses the influence of several factors

[59] The method of calculation these indicators is presented in Appendix 1

on the repayment rate. This specific analysis is conducted since the repayment rate is considered as the most important performance indicator of microfinance institutions. Before entering into this analysis, a brief discussion on the geographic, demographic, economic situation as well as the growth and development of the LPD of Gianyar district in Bali aims to give a socio-economic environment background to the analysis.

7.2 SOCIO-ECONOMIC INDICATORS OF GIANYAR DISTRICT

Gianyar, which geographically lies between the banks of the Ayung and Melangit rivers, is one of Bali's richest areas in terms of art, music, dance and antiquities as well as fertility of the land (Hofer 1996). Hofer also points out that Gianyar district distinguishes itself from other districts in that it has no beaches, no mountain lakes, and no grand hotels. Nevertheless, at present, Gianyar district, with a population of 395,000, is one of the growth engines of Bali's provincial economy. According to Statistics of Bali Province 2001, with Gross Regional Domestic Product (GRDP) of Rp 2,307 billion, Gianyar was the fourth biggest contributor (12.16%) to Bali province after Badung district (20.86%), city of Denpasar (19.19%), and Buleleng district (12.19%). Based on GRDP per capita, Gianyar was ranked third after Badung district and the city of Denpasar in the same period. During the Indonesian economic crisis from 1997 until 1999, the Gianyar economy still experienced positive economic growth. Its real economic growth rates were 6 and 4.5 percent per annum in 1997 and 2001 respectively and the economic growth rate in 2001 was higher than Bali and the national average growth rate of 3.4 and 3.3 percent per annum respectively.

The steady economic growth of Gianyar district over the period 1997 to 2001 was partly due to the local economy relying highly on small-scale industries (handicraft industries) and tourism-related sectors that were not influenced by the condition of the domestic economy.[60] The small-scale industries that did not rely on raw material or heavy capital imports (which is the case in Gianyar) even largely benefited from the

[60] Data from the Central Board of Statistics (CBS) of Bali Province reveal that the number of foreign tourists arriving in Bali increased from 1,187,153 in 1998 to 1,355,799 in 1999 (CBS of Bali, Bali in Figures, 1999).

economic crisis due to *rupiah* depreciation (Rice, Herustiati et al. 2002). The *rupiah* depreciation to the US dollar reduced the prices of products for buyers in the export market. Such a benefit was also experienced in Central and West Java. During the crisis small scale industries (rattan and wood in particular) in these two provinces were still able to export their products and benefit from *rupiah* depreciation (Rice, Herustiati et al. 2002). Confirming this finding, a limited survey of small firms in the Jepara cluster (Central Java) showed that there was marked growth in the number of firms and joint ventures entering export markets and the firms were actually expanding during the crisis (Sandee, Andadari et al. 2000). Sandee *et al* conclude that the crisis offered new opportunities to small firms to participate in the export trade and benefit from a substantially lower exchange rate.

Table 7.1 Socio-economic Indicators of Gianyar District of Bali Province, 1997 and 2001

INDICATORS	1997	2001
▪ Total population	350,147	370,788
▪ Labour force participation rate (%)	n.a	72.4
▪ Open unemployment rate (%)	n.a.	1.5
▪ Gross Regional Domestic Product at current price (billion Rp)	1,171	2,307
▪ GRDP per capita (million Rp) at current price	3	5.8
▪ Rate of economic growth at constant price 1993 (%)	6	4.5
▪ Share of manufacturing sector in GRDP (%)	19	20
▪ Share of agricultural sector in GRDP (%)	17	16
▪ Share of trade, restaurants & hotels in GRDP (%)	29	29
▪ Inflation rate (%)	10.3	11.5
▪ Employment in manufacturing industry (%)	32	33
▪ Employment in agricultural sector (%)	29	19
▪ Employment in trade, restaurants & hotels sector (%)	15	23

Note: n.a. = not available

Sources: CBS of Gianyar District, *Gianyar in Figures 2000*, 2000; CBS of Gianyar District, *Socio-economic Profile of Gianyar Population 2001*, 2002; Bank Indonesia, *Regional Economic-Financial Statistics of Bali*, 2002.

The important role of small-scale industries in the Gianyar economy was indicated by the share of manufacturing[61] in the GRDP (see Table 7.1). The textile, leather products and footwear, and wood products and other wood products sub-sectors are the predominant industries in the district. The district had only 74 large and medium sized industrial establishments, but boasted 25,100 small-scale industrial establishments which employed 70,914 workers and accounted for 88 percent of total employment in the manufacturing sector (CBS of Gianyar 2000). As mentioned in Chapter 5, these small-scale industries are concentrated in four centres in Gianyar, Sukawati, Ubud, Tegallalang, and Gianyar sub-districts. During the economic crisis, those small-scale industries were still able to produce and export their products, and in turn contribute to the area's economic growth.

The economic structure of Gianyar district is similar to the structure of the provincial economy. This similarity supports the choice of the Gianyar district as the case study. Then it is expected that the findings of this study will also be able to describe the nature of the LPD in Bali province. Gianyar's economy is dominated by three main sectors - manufacturing, agriculture, and trade and the restaurants and hotels sector - which contribute about 65 percent to the GRDP (see Table 7.1). The remaining 35 percent was contributed by several other sectors, including mining and quarrying, construction, transportation and communication, finance, rent and business services, and other services. However, in contrast to other districts, the manufacturing sector is the largest contributor to Gianyar's economy. In 1997, the contribution of this sector was about 19 percent, increasing to 20 percent by 2001. This figure is much higher than the Bali provincial level of 8.5 percent (CBS of Bali 2001). The total contribution of the tourism related sectors was greatest with 29 percent in both 1997 and 2001. The increasing contribution of the light industry and service sectors was accompanied by the decreasing contribution of the agricultural sector, which decreased from 19 percent in 1997 to about 16 percent in 2001. This figure was lower than the Bali provincial level of 19.1 percent. These figures demonstrate that the economy of Gianyar is based on

[61] According to the classification of the Central Board of Statistics of Indonesia (CBS, 2001), manufacturing sector consists of oil & gas manufacturing and non-oil & gas manufacturing. Non-oil and gas manufacturing consists of several sub-sectors such as textile, leather products & footwear, and wood products & other wood products.

light industry and the service economy, indicating that the economic transformation from agricultural-based to light industrial and services-based economy which is occurring at a slower rate in Bali province has already happened in Gianyar district.

The economic transformation in Gianyar district, however, seems to be slightly different from the pattern of economic transformation in general. Based on two studies – in both developed and developing countries - some scholars argue that the economic transformation starts with the increasing contribution of the industrial sector, followed by the increasing contribution of services sectors to the economy (Kuznets 1966; Chenery and Syrquin 1975). In the case of Gianyar, however, economic transformation started with the increasing role of the services sector, followed by light industry (handicraft industries). The rapid growth of the services sectors in Gianyar, which is very closely related to the tourism sector, might be due to the Bali Tourism Master Plan of 1973 which has been discussed in Chapter 4. The development of tourism related sectors in turn encouraged the development of light industries, especially handicraft industries that complement the tourism development.

The process of economic transformation of the Gianyar district has also influenced the employment structure. Table 7.1 shows that employment was predominantly absorbed in the three main sectors: manufacturing, trade, hotel and restaurants, and agriculture. In 1997 and 2001, the employment absorbed by these three sectors achieved around third-quarters of total employment in Gianyar district. The manufacturing sector absorbs more than 30 percent of employment - which was much higher than the provincial level of 15 percent - and shows an increasing trend. In the same period, however, the agricultural sector showed a decrease. While at the provincial level this sector is still able to absorb around 34 percent of employment, in Gianyar district it is only 19 percent.

In regard to manpower, Table 7.1 also shows that this is better in Gianyar district than at the provincial level. This was indicated by the relatively high labour force participation rate of 72.4 percent in 2001, compared to the provincial level average of

63.4 percent. Labour force participation rate refers to the ratio between the labour force (those aged 15 to 64) and the total number of people in the same age group (CBS of Indonesia 2002). In addition to the labour participation rate, the unemployment rate of 1.5 percent in Gianyar district was lower than the provincial figure of 2.8 percent.

Based on all of the figures discussed above, it can be presumed that Gianyar's macro-economy provides a good opportunity for economic and business activities. The trend in economic growth that accompanied economic structural transformation and employment growth, particularly in the manufacturing and tourism-related sectors, indicate that these two sectors hold potential for further development in the future. Such development can be expected to increase the employment opportunities and in turn increase the social economic welfare of people within Gianyar district.

This local development potential could be actualised through, for instance, the existence of appropriate policies from local government at every level and through the participation of the local community (Esman and Uphoff 1984; Uphoff 1986; Blakely 1994). The development of appropriate policies will also provide an opportunity to strengthen local institutions and strengthen local communities (Ostrom, Schroeder et al. 1993; Snow 1999). Referring to the Regional Government Law of 1999 that a village has the right to raise funds and also may establish their own business entities in order to strengthen and support their local economy (Government of Indonesia 1999), the development of LPDs in Bali – which have been developed since 1984 - has been an appropriate policy to stimulate and strengthen rural economic development in Gianyar district particularly, and in Bali province in general.

7.3 THE GROWTH OF LPD OF GIANYAR DISTRICT

The first Village Credit Institution (LPD) established in Gianyar district was LPD Manukaya, as one of the LPD pilot projects, located in the custom village of Manukaya in 1984. Subsequently, the growth of LPDs in Gianyar district has been very fast. On

the one hand, as has been discussed in Chapter 6, the rapid rise of LPDs is due to the increasing demand of the Balinese people for rural financial institutions. As noted earlier, in many custom villages that already owned LPDs, the LPDs have performed well in terms of their abilities to meet their needs for an easy access for credit. On the other hand, the provincial government of Bali and Bank BPD Bali actively supported the establishment of new LPDs by provision of funds as initial capital and supervision for the establishment of the LPDs. As mentioned in Chapter 6, the provincial government of Bali plans to set up one LPD in each of the 1,600 custom villages.

Using longer time series data and by examining the changes of the LPDs performance over a longer time period, would yield stronger findings. However, as mentioned earlier in Chapter 5, because of the limitations of time and other resources this study only focuses on the condition of the LPDs in the period 1999-2001. As seen in Table 7.2, at the end of 2001, it 174 LPDs had been established in Gianyar district, and they were spread over all of the seven sub-districts. There are 103 LPDs located in four sub-districts which form the centre of handicraft industries, and 71 located in three agricultural-based sub-districts. These LPDs together employ 873 employees directly.

In terms of asset development, the Gianyar LPDs have also experienced a remarkable growth. As shown in Table 7.2, in only two years between 1999 and 2001, total assets increased almost 2.5 times from Rp58 billion to Rp125 billion. This growth was mainly caused by the growth of loans outstanding which more than doubled from Rp36 billion in 1999 to Rp89 billion in 2001. In addition, the establishment of new LPDs has increased the total assets.

Meanwhile, equity also more than doubled from Rp10.9 billion in 1999 to Rp25.4 billion in 2001. Equity here refers to value of invested capital (initial investment) plus retained earnings. The increasing equity resulted from the increase of retained earnings (total profit). As shown in Table 7.2, total profit of the LPDs has increased from Rp4.4 billion in 1999 to Rp10.2 billion in 2001. In addition to the profit, the initial investment for new establishments of LPDs has raised the total equity.

The main activity of the LPDs is lending-savings mainly to small-scale entrepreneurs, small traders, and farmers. The volume of loans outstanding also rapidly increases from year to year. The data in Table 7.2 shows that in 1999 the volume of loans outstanding was Rp36 billion and in 2001 this amount increased to Rp89 billion. Moreover, other than the volume of loans outstanding, the number of borrowers also increases from 36,454 to 49,593 in the same period.

Table 7.2 General indicators of Village Credit Institutions (LPDs) within Gianyar District of Bali Province, 1999-2001

General Indicators	1999	2001
Information on the Village Credit Institutions (LPD):		
▪ Number of LPDs	142	174
▪ Number of staff	723	873
▪ Total assets (billion Rp)	58	125
▪ Total equity (billion Rp)	10.9	25.4
▪ Total profit (billion Rp)	4.4	10.2
Lending and savings activities:		
▪ Volume of loans outstanding (billion Rp)	36	89
▪ Number of borrowers	36,454	49,593
▪ Average loans size per borrower (000 Rp)	954	1,603
▪ Volume of time deposits (billion Rp)	23	47
▪ Number of time deposits account (depositors)	6820	7948
▪ Average deposit per depositor (million Rp)	3.5	5.7
▪ Volume of savings (billion Rp)	22.5	50
▪ Number of savings account (savers)	81,178	114,994
▪ Average savings per saver (000 Rp)	243	415
▪ Bank deposits in Bank BPD Bali (billion Rp)	20	29
Financial intermediation indicators:		
▪ Deposits to loan ratio (DLR) in %	111	106
▪ Savers and depositors to borrowers ratio (%)	241	248

Source: PLPDK, *Financial Report of LPD Gianyar District of Bali Province*, 1999 and 2001 (computed by the author).

The development indicators of LPDs from the deposit side are savings and term deposits. Both savings and term deposits are very high, not only in terms of the value of funds generated, but also in terms of the number of savers and depositors. Table 7.2 shows that the total amount of funds generated from the clients through savings and term deposits exceeded the total amount of loans outstanding in 1999 and 2001. In 1999 the generated funds from the clients was Rp45.5 billion while the total of loans outstanding was Rp36 billion. In 2001 these amounts increased to Rp97 billion and Rp89 billion respectively. Table 7.2 also shows that the number of savers and depositors also exceeded the number of borrowers in 1999 and 2001. In 2001, the number of borrowers, 49,593, was much lower than the number of savers and depositors accounts at 122,942. This high growth in number of borrowers, outstanding loans, savings and deposits are evidence of strong client demand.

The figures above will in turn affect the deposits to loans ratio (DLR) and savers (and depositors) to borrowers ratio. Table 7.2 shows that these two ratios were higher than 100 percent and the most remarkable thing is that the savers and depositors to borrowers ratio exceeded 200 percent in 1999 and 2001. This phenomenon implies that the LPDs in Gianyar have succeeded in achieving their role as financial intermediaries and enhancing their outreach, which is a proxy of their positive impact on rural economic development. There are five main reasons that could explain this phenomenon. First, the high savers and depositors to borrowers ratio might be caused by social and cultural ties (social cohesion) between the people in a custom village and its LPDs. As discussed in Chapter 6, the LPD is owned, managed, and used by the people in a custom village. It is argued that the closer a microfinance institution is to the clients, the stronger its comparative advantage (Snow 1999). This comparative advantage has resulted in strong existing client loyalty and attracted new clients which in turn increases their demand on financial services – in this sense savings and term deposits - offered by the LPDs and, finally, influence the ratio. Secondly, the people have easy access to reach the LPD since it is located in a custom village. Therefore, transportation cost is very low or even zero. This could also be an attractive factor for the clients to save their money in LPDs.

Thirdly, as has also been discussed in Chapter 6, the LPDs use a simple and easy procedure - both in lending and saving services - and use mobile banking techniques to reach their clients. The techniques are appropriate, in particular, when very small savings amounts are involved and when weekly or biweekly visits could satisfactorily meet the financial needs of the savers (Yaron 1994). Yaron (1995) also points out that these techniques have been applied in other microfinance institutions in Indonesia such as BKK (Sub-district Credit Institutions) of Central Java and the BRI Unit Desa and have succeeded in enhancing accessibility of savers to the institution, and vice versa (Yaron 1994).

Fourthly, the competition among financial institutions is not tight at the village level. Other than the LPDs, in Gianyar district there are three rural financial institutions at sub-district level, the People's Credit Bank (BPR) owned by private enterprise, Village Unit Cooperatives (*Koperasi Unit Desa* or *KUD*) owned by the Department of Cooperative and Small-scale Enterprise Development and BRI Unit Desa System owned by Bank BRI. Even though the three institutions are competitors of the LPDs, the main market segments of these institutions are different from the LPDs's market segment. The BPR serve mainly middle class people in the sub-district. The Village Unit Cooperative has a main activity which is to disburse program credits from the Government to farmers, while BUD tends to give credit mainly to medium-scale enterprises. As a result from this loose competition, combined with the advantages of the LPD in terms of its social and cultural ties (social cohesion) with its community and its simple and easy procedure, the LPDs have been more competitive. The LPDs have been able to attract more clients than their competitors and, in turn, influence the ratio, as pointed out by the Chairpersons of the LPDs interviewed. Moreover, according the Chairpersons (Ardana, Kurniawan, and Cendikiawan, interviews on 7 and 8 February 2002; 21, 23, 25, and 26 February 2003) the interest rates – both lending and savings rates – do not influence the clients' decision to borrow some money, or to save their money in the LPDs. The high repayment rate and the low delinquent borrowers ratio of the LPDs - discussed in the next section - are evidence of the willingness of the clients

to pay the interest and to repay their loans on time. Lastly, the growth of those figures might also be affected by the stable and growing economy of Gianyar district, as discussed above. It is argued that microfinance institutions can evolve sustainably in a stable and growing economy (Chaves and Gonzales-Vega 1996; Franks 2000; Robinson 2001).

From another perspective, the rapid growth in the number of borrowers, savers, depositors, loans outstanding, savings and deposits - as has been noted earlier – is evidence of strong client demand in Gianyar district. According to the interviewees and Oka (1999), the rapid growth is an indication that the LPDs have – as financial institutions - suited the needs of rural people and succeeded in developing their trust. In other words, the LPDs have a role as a trustworthy intermediary financial institution in Gianyar district. This confirms Robinson's (1998, 2000) statement that in the last two decades some of the microfinance institutions in Indonesia - such as BRI Unit Desa and Village Banks (*Badan Kredit Desa* or *BKD*) - have been able to shift the paradigm from credit delivery to sustainable financial intermediation.

On the contrary, the high savings and deposits growth rates could be a burden for the LPDs to pay the interest cost. To avoid this problem the LPDs deposit some of their unloanable funds (excess liquidity) – at market interest rate – in Bank BPD Bali in accordance to the Bali Provincial Regulation No.8/2002, Article 7 (Government of Bali 2002). Table 7.3 shows that the LPDs' deposit in Bank BPD Bali was quite high. It was Rp20 billion in 1999, or about one half of savings plus term deposits, and Rp29 billion in 2001, or about one-third of savings plus term deposits. Other than its operational income, this large number of the LPD deposits in Bank BPD Bali also contributed to the total income of the LPDs and, in turn, increased its total profit from Rp4.4 billion to Rp10.2 billion in 1999 and 2001 respectively, as shown in Table 7.2. On the other hand, this large deposit to Bank BPD Bali also indicates that the absorption capacity of rural people for credit is still limited. This condition, however, is mainly caused by the small and limited operational area of each LPD which is restricted to only one custom village according to the regulation mentioned above (Government of Bali 2002).

7.4 PORTFOLIO QUALITY, LEVERAGE, AND CAPITAL ADEQUACY

Portfolio quality, particularly, the repayment rate is the most important performance indicator of microfinance institutions since it has a large bearing on whether a microfinance institution is likely to be self-sufficient and sustainable in the long run (Yaron 1994; Sharma and Zeller 1997; Christen 1998; Zeller 1998; Woolcock 1999). Woolcock (1999) points out that the most important indicator of a microfinance institution's performance is its loan repayment rate, since this has a major bearing on whether a program is likely to be financially sustainable. Yaron (1994) also argues that a high profit earned by microfinance institutions cannot be used as the only indicator of self-sustainability of the institutions, since a high profit could be attained just in a short period only. Attaining a high rate of loan collection (repayment rate) is a necessary condition for a microfinance institution to become self-sustainable in the long run. Loan losses have often been the largest cost borne by the institutions and the principal cause of insolvency and illiquidity. The importance of the portfolio quality indicator is also reflected in the healthiness criteria of banking institutions set up by the Central Bank - the so-called CAMEL criteria[62] – that gives a high weight of thirty percent for this indicator (Bank Indonesia 1997).

In this study, portfolio quality performance is assessed using two indicators, repayment rate and delinquent borrower ratio. According to Bank BPD Bali (2000), the loans portfolio of the LPD is classified into four categories: pass, doubtful, sub-standard, and loss. In this study the repayment rate refers to the ratio between the first three categories of outstanding loans divided by the total outstanding loans (all four categories). Delinquent borrower ratio refers to the number of borrowers who do not repay their loans until overdue relative to total borrowers. Based on the data in Table 7.4, the LPDs within Gianyar district perform a good portfolio quality, which is reflected by the high repayment rate and low delinquent borrowers ratio.

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[62] The CAMEL criteria is presented in Appendix 2.

In 1999 the repayment rate was 95 percent and this increased to 97 percent in 2001 (Table 7.3). Compared to the other microfinance institutions in Indonesia, these figures are high.[63] The repayment rate of *Badan Kredit Kecamatan* (Sub-district Credit Organisation) of Central Java was only 80 percent. Meanwhile, the repayment rate of the BRI Unit Desa System was estimated at 95 percent (Yaron, Benjamin et al. 1998). In addition to a high repayment rate, its delinquent borrowers ratio was only 0.5 percent in 1999 and decreased to 0.4 percent in 2001. Following Christen *et al* (1995, p.3), these high repayment rates and the low delinquent borrowers ratio of the LPDs is evidence of the willingness of the clients to pay the interest rate even though interest rates are significantly above the rate of inflation.

Table 7.3 Portfolio quality, leverage, and CAR of LPDs within Gianyar District of Bali Province, 1999 and 2001 (means)

Indicators	1999	2001
▪ **Portfolio quality:**		
Repayment rate (%)	95	97
Delinquent borrowers ratio (%)	0.5	0.4
▪ **Leverage** (Debt to Equity Ratio) in %	220	210
▪ **Capital adequacy ratio** (CAR) in %	31	61

Source : PLPDK, *Financial Report of LPD Gianyar District of Bali Province*, 1999 and 2001 (computed by the author).

There are four interrelating reasons that could explain the good portfolio performance. First, in accordance with regulations, an LPD only gives loans to the clients who have their own business, such as small-scale industry entrepreneurs, farmers, or small traders. The credit should be used for productive economic activities purposes (Government of Bali 2002) . For the LPDs management, it is relatively easy to identify if credit applicants have business activities as the operational area of each LPD is

[63] This comparison is not intended to judge that the LPD has a better repayment rate than the others, since it was calculated in a different period and the methods of calculation might be different. Nevertheless, it is still useful as a general illustration.

limited to a custom village in which most of the people know each other. As a result, this could positively influence their repayment ability. As has been discussed in Chapter 2 and Chapter 6, the use of village agents, such as the custom village leader in Bali, in screening potential borrowers and collecting repayment would help to mitigate any information problems that might hamper the performance of microfinance institutions when lending to small entrepreneurs (Timberg and Aiyar 1984; Onchan 1992 ; Yaron 1992; Chaves and Gonzales-Vega 1996; Fuentes 1996). In addition, by gaining access through the agent to village-level enforcement mechanisms, such as social sanctions, the microfinance institution may also mitigate some of the problems it faces when collecting repayment.

Second, most of the borrowers are from the custom village where the LPD is located. As discussed previously, the LPDs are rooted culturally and legally in the custom village community. The LPDs are community financial institutions which are owned, managed, and used by the members of the custom village. As argued by Oka (1999) and some interviewees, including the Chairpersons of the LPDs, local government officers, and members of the commissioner board, this embeddedness of the LPDs within its local institutions has caused the clients' sense of belonging to their LPD and moral obligation to help its development. Moreover, in credit mechanisms including the screening process and contractual enforcement, the LPDs management cooperates with the Board of Commissioners (*Dewan Pengawas*) - led by the custom village leader (*Bendesa Adat*) - who knows the character (reputation) of the clients well. This technique, as discussed in Chapter 6, has been comparatively efficient in avoiding costly mistakes in assessing the probability of loan repayment.

Third, the custom (social) sanctions - that could be applied in accordance with the written custom village regulations - have forced the borrowers to repay their credits timely. According to the interviewees mentioned earlier and Oka (1999, p.17), the custom village regulation has been effective in overcoming the problem of delinquent borrowers or low repayment rates. Finally, the LPDs staff members have a high level of mobility in respect to collecting loan repayments. An LPD staff member visits the

clients in their houses (mobile banking techniques) to collect savings deposits and loan repayments in person. This system has also forced the clients to repay their loans regularly and timely.

In summary, it could be argued that the good portfolio quality performance of LPDs is affected by the practical arrangement of LPD management using custom regulation which includes social norms, sanctions, and involvement of the custom village leader in screening process and contractual enforcement of loans (informal institutions), regulations set up by the Central Bank (formal institutions), and the mechanism of collecting loan repayments applied by the LPDs management.

The leverage and capital adequacy ratio (CAR) reflects the structure and sufficiency of the capital of microfinance institutions. It is argued that sufficient capital is also one of the key factors affecting the healthiness and sustainability of microfinance institutions, since sufficient capital encourages lenders (if the microfinance institutions borrow funds from, for instance, commercial banks) and depositors to have confidence in the microfinance institutions relative to its ability to provide for losses and fund future growth (Ledgerwood 1999).

In this study, the leverage of LPDs is calculated using the debt to equity ratio (DER). The Gianyar LPDs have a relatively high DER of larger than two hundred percent. This high DER was mainly caused by the high value of clients' savings and deposit since the LPDs did not borrow any funds from other institutions. The clients' savings and deposits are classified as a debt in banking or microfinance institutions (Ledgerwood 1999, p.224). However, as shown in Table 7.4, the DER of the LPDs slightly decreased from 220 percent in 1999 to 210 percent in 2001. The decrease of DER in that period was mainly caused by the increase of the equity of the LPDs which doubled in 2001 as shown in Table 7.3. The increasing equity trend indicates that the LPDs have been experiencing an improved capital structure that in turn could enhance their the ability to be sustainable microfinance institutions

Concerning leverage, Ledgerwood (1999, p.224) argues that any microfinance institution has to maintain a proper balance between debt and equity to ensure that the equity or viability of the institution is not at risk. Further, she argues that when a microfinance institution (such as the LPDs) has a large amount of equity and very little debt, it is probably limiting its income-generating-potential by not making use of external sources of debt. In this respect, the LPDs have chosen a profitable way, by offering a line of credit or a loan that finance from saving at 0.8 percent (for savings) and 1.3 percent (for term deposits) monthly, and onlent the generated funds (savings and term deposit) to the clients in the range of 2.25-2.75 percent monthly. Therefore, as Ledgerwood (1999) states, it may be better for a microfinance institution to increase its liabilities (in particular savings and term deposits), when it is possible to increase its income-generating assets (its loan portfolio), and this is the case with the LPDs.

According to banking regulations, there is no restriction on the leverage (DER) of any microfinance institution in Indonesia, including the LPDs. However, there is a regulation from the Central Bank (Bank Indonesia 1997) that any microfinance institution has to maintain the loan to deposit ratio (LDR) at around 95 percent and the minimum capital adequacy ratio (CAR) at 10 percent to ensure the security of the clients' savings (including their deposits) and the viability of the institution.

Based on the capital adequacy ratio (CAR),[64] the Gianyar LPDs also show a good performance. Table 7.3 shows that the LPDs have a high CAR which remarkably increased from 31 percent in 1999 to 61 percent in 2001. This figure is very much higher than the minimum CAR of 10 percent for a healthy microfinance institution set up by the Central Bank (Bank Indonesia 1997). Like the decreasing trend in DER, the increasing trend in the CAR is mainly caused by the rapid growth in the equity, which supports the previous findings that the potential of LPDs to be self-sustained microfinance institutions is high.

[64] CAR refers to the level of capital required to absorb potential losses while providing financial sustainability. The calculation method of CAR is presented in Appendix 1.

As stated in Chapter 1, one of the research questions of this study is to investigate whether or not there is a different performance between the LPDs located in handicraft-based sub-districts (region) and those in agricultural-based sub-districts in order to assess the influence of different economic bases on the performance and sustainability of the LPDs. In so doing, the Mann-Whitney test is used in this study. The arithmetic means, p-value, and the results of the test are presented in the second, third, fourth, and fifth column of Table 7.4.[65] However, the Mann-Whitney test results reveal that there is no statistically significant difference between portfolio quality, leverage, and capital adequacy ratio of the LPDs in those two regions. In this case, it can then be concluded that the economic base of a region does not have a different effect on the portfolio quality, leverage, and capital adequacy ratio of the LPDs. This lack of difference in these performance indicators also indicates that the prudential regulations regarding the capital adequacy ratio and liquidity (CAMEL criteria) set up by the Central Bank and the provincial government of Bali has the same effect on the performance of LPDs, both LPDs located in handicraft-based sub-districts (region) and those in agricultural-based sub-districts.

Table 7.4 Arithmetic Means and the Results of the Mann-Whitney Test for Portfolio Quality, Leverage, and CAR between Two Group of LPDs, 2001

Indicators	2001			
	Handicraft industry based sub-districts	Agricultural based sub-districts	two-tailed p-value*	The Mann-Whitney test results

[65] This procedure is applied to other performance indicators in subsequent sections. The computer results of this test are presented in Appendix 9.

▪ **Portfolio quality:** Repayment rate (%)	98.4 (n=91)	96 (n=62)	0.28	no difference
Delinquent borrowers ratio (%)	0.3 (n=91)	0.6 (n=62)	0.61	no difference
▪ **Leverage** (Debt to Equity Ratio)	2.3 (n=83)	1.9 (n=57)	0.38	no difference
▪ **Capital adequacy ratio** (CAR) in %	65 (n=91)	56 (n=62)	0.37	no difference

Note: * Critical p-value is 0.05 (p-value<0.05 means difference, otherwise).

Source : PLPDK, *Financial Report of LPD Gianyar District of Bali Province*, 2001 (computed by the author).

Even though the portfolio quality of the LPDs in those two regions is not statistically different, there could theoretically be two main reasons explaining why the portfolio quality of the LPDs in the handicraft-based sub-district is slightly higher than that in the agricultural-based sub-districts. First, the income stability of the clients is different. The clients located in the handicraft-based sub-districts have a relatively more stable income all year around since their products can be produced and marketed on a daily basis. In comparison, the income of the clients in the agricultural-based sub-districts is less stable since their products are seasonal and sometimes their production activities are full of uncertainty due to pests, or changing weather conditions such as drought. This is a special feature of the income of people in the agricultural sector (Besley 1994). The experience of *BRI Unit Desa* or *BUD* indicates that the drought affected the income of farmers in rural areas, and in turn the repayment rate of BUD (Patten, Rosengard et al. 2001). Hence, income stability would affect the loan repayment ability of the clients. Second, the ratio of borrowers per staff reflecting the workload of each staff affects the portfolio quality. A lower ratio means that the workloads of each staff collecting loan repayments is lighter, and *vice versa*. The data in Table 7.5 shows that

the ratio for the LPDs located in handicraft-based sub-districts is lower than the ratio in agricultural-based sub-districts and, in turn, results in a higher repayment rate.

7.5 PRODUCTIVITY AND EFFICIENCY

As mentioned in Chapter 5, productivity refers to the volume of business that is generated (output) for a given resource or asset (input), while efficiency refers to the cost per unit of output. Based on those two indicators the LPDs within the Gianyar district also show a good performance. Productivity indicators, which are measured by several indicators (see Table 7.5), reveal an increasing trend between 1999 and 2001, which means the productivity of staff increased during this period. Productivity per staff member, which is reflected by the workload of the average staff member, increased from 108 to 125 savers per staff member in 1999 and 2001 respectively. On the other hand, this increase could augment the burden on the staff particularly in monitoring the clients and enforcing the contractual agreement with the clients to keep a good repayment rate. This issue will be explored in section 7.8 where the influence of the number of staff on the repayment rate is estimated using logistic analysis.

The size of savings and term deposits per staff member has also increased from Rp31 million in 1999 to over Rp50 million in 2001. Meanwhile, the average loans outstanding managed per staff member has almost doubled from Rp48 million in 1999 to Rp93 million in 2001. In some studies the productivity indicators were sometimes treated as outreach indicators (Yaron 1992; Yaron 1994; Yaron, Benjamin et al. 1998). Hence, these figures imply that the outreach of the LPDs of Gianyar district has increased in that period.

As argued in Chapter 6, one internal factor that might contribute to this increasing productivity of the LPDs staff is the remuneration system. As discussed in Chapter 6, three Chairpersons of LPDs interviewed pointed out that all management staff are satisfied with the remuneration system which is indicated by the work motivation of the staff. According to the three Chairpersons, the work motivation of the staff is high. The

interviews with the Chairpersons (7 and 8 February 2002; 21, 23, 25, 26 February 2003) revealed that the LPD staff are favourably disposed to the current remuneration system of basic salary and incentives which they regard as competitive and fair. However, an external factor must also be considered, namely the increase in clients of the LPDs - including borrowers, savers, and depositors - that have forced the staff to serve more clients which in turn increases the productivity and workload of the staff members.

Table 7.5 Productivity and Efficiency of LPDs within Gianyar District of Bali Province, 1999 and 2001 (Means)

Indicators	1999	2001
Productivity:		
▪ Number of borrowers per staff	49	67
▪ Loans outstanding per staff (million Rp)	48	67
▪ Number of savers per staff	108	111
▪ Savings per staff (million Rp)	31	34
▪ Number of depositors per staff	9	8
▪ Time deposits per staff (million Rp)	31	35
Efficiency:		
▪ Operating cost ratio	0.20	0.22
▪ Salaries as a percentage of average portfolio outstanding	0.006	0.008

Source: PLPDK, *Financial Report of LPD Gianyar District of Bali Province*, 1999 and 2001 (computed by the author).

The LPDs' efficiency is measured by two indicators, which are the operating cost ratio which refers to operating costs relative to the average portfolio outstanding, and salaries as a percentage of average portfolios outstanding, as mentioned in Chapter 5. Based on those two indicators as shown in Table 7.5, it could be concluded that LPDs are efficient. The data in the Table show that their operating cost ratio was 20 percent in 1999 and 22 percent in 2001. This means that the LPDs fully covered the cost of day-to-day operations, including salaries and administrative costs, with revenues from interest. The LPDs revenues are gained almost exclusively from lending, with loanable funds derived from savings and term deposits, since most of them do not have any business activity other than lending and saving. Based on a study of USAID in several developing countries (Indonesia, Bangladesh, Bolivia, Senegal, Dominica, Costa Rica,

Colombia, and Niger), successful microfinance institutions tend to have operating cost ratios of between 13 and 21 percent of their average loan portfolios (Christen, Rhyne et al. 1995). Compared to these figures, the operating cost ratio of LPDs is close to the upper end of the range, meaning that the LPDs are still efficient.

Meanwhile the salaries ratio of LPDs is extremely low at around 0.7 percent. Christen *et al* (1995) state that the ratio of many successful microfinance institutions is running between 4 and 16 percent of the average portfolio outstanding. This low salary cost is partly because the LPDs use local community personnel as their staff in managing the LPD and the local cost of living as a determining factor for the basic salary, as discussed in Chapter 6. Furthermore, the local government regulates the remuneration system of the LPD's staff, which is a function of the financial capacity (profits and loan instalments recovered) of the LPD, and thus is observable and measurable.

This high efficiency of LPDs could be attributed to two main factors; first low transaction costs. As discussed in Chapter 6, the LPDs have applied a flexible arrangement in their delivery mechanism. They are local and user-owned financial institutions whose operational coverage of a small area of a custom village allows the LPDs management to have an intimate knowledge of their clients and harness mechanisms of social control in the screening and contractual enforcement process. This mechanism, as discussed in Chapter 6, has reduced and minimised the transaction costs for both the lender and borrower. Secondly, low salary cost. The remuneration system which is based on the local cost of living and financial capacity (profits and loan instalment recovered) of the LPDs has also contributed to the high efficiency of the LPDs.

Table 7.6 Arithmetic Means and the Results of the Mann-Whitney Tests for Productivity and Efficiency between Two Groups of LPDs, 2001

Indicators	2001			
	Handicraft industry based sub-districts	Agriculture based sub-districts	two-tailed p-value*	The Mann-Whitney test results
Productivity:				
▪ Number of active borrowers per staff	57 (n=91)	66 (n=62)	0.13	No difference
▪ Loans outstanding per staff (million Rp)	111 (n=91)	67 (n=62)	0.00	Difference
▪ Number of savers per staff	135 (n=91)	111 (n=62)	0.15	No difference
▪ Savings per staff (million Rp)	63 (n=91)	34	0.00	Difference
▪ Number of depositors per staff	8 (n=91)	8 (n=62)	0.55	No difference
▪ Time deposits per staff (million Rp)	63.6 (n=83)	35.7 (n=57)	0.01	Difference
Efficiency:				
▪ Operating cost ratio	0.22 (n=91)	0.22 (n=62)	0.55	No difference
▪ Salaries as a percentage of average portfolio outstanding	0.007 (n=91)	0.008 (n=62)	0.05	No difference

Note: * Critical p-value is 0.05 (p-value<0.05 means difference, otherwise).
Source: PLPDK, *Financial Report of LPD Gianyar District of Bali Province*, 2001 (computed by the author).

Comparing the productivity indicators between the LPDs located in handicraft based and agricultural based sub-districts (Table 7.6), three out of six productivity performance indicators – the number of active borrowers per staff, the number of

savers per staff, and the number of depositors per staff – are not statistically different for these two different regions. However, the other three indicators – loans outstanding per staff, savings per staff and deposits per staff – are statistically different. The higher figure of these three indicators of the LPDs located in handicraft based sub-districts is most probably caused by the different types of business activities of the majority clients, the larger population, and the higher level of per capita income (GRDP) of the clients in those sub-districts, as shown in Table 5.1 in Chapter 5.

The efficiency indicators - measured by the operating cost ratio and salaries as a percentage of average portfolio outstanding - are statistically not different between the two regions. This indicates that the economic base of a region does not affect the efficiency of the LPDs. As noted above, this is partly because the LPDs cover a small operational area, apply a uniform delivery mechanism, and have similar transaction costs. In addition, the LPDs have applied standardised cost measures, for instance the remuneration system, that has resulted in a similar efficiency rate.

7.6 PROFITABILITY AND FINANCIAL VIABILITY

Ledgerwood (1999) points out that profitability and efficiency are key factors shaping the financial viability (operational and financial self-sufficiency) of a microfinance institution. The discussion in the previous section revealed that the LPDs in Gianyar district are efficient. This section deals with their profitability and financial viability which would influence the sustainability of the microfinance institutions.

Using the consolidated financial reports of the Gianyar district LPDs it is found that they have been profitable. The evidence that LPDs are fully profitable lies in the positive adjusted returns on assets (ROA) and return on equity (ROE). Table 7.7 shows that the ROA adjusted increased from 10 percent in 1999 to 13.5 percent in 2001. The indicators are high enough to gain profit and show a rising trend from 1999 to 2001. Compared to the adjusted ROA of LPDs at the provincial level of 7.4 percent (Christen, Rhyne et al. 1995), this figure is higher.

Table 7.7 Profitability and Financial Viability of LPDs within Gianyar District of Bali Province, 1999 and 2001 (Means)

Indicators	1999	2001
Profitability:		
▪ Return on Asset adjusted (ROA) in %	10	13.5
▪ Return on Equity adjusted (ROE) in %	23	52
Financial viability:		
▪ Operational self-sufficiency (%)	199	196
▪ Financial self-sufficiency (%)	181	163

Source: PLPDK, *Financial Report of LPD Gianyar District of Bali Province*, 1999 and 2001 (computed by the author).

The adjusted ROE experienced a high growth from 23 percent in 1999 to 51 percent in 2001. These figures are much higher than the inflation rate of 10.3 and 11.4 percent per annum in the same period. They are also much higher than the term deposit interest rate of commercial banks which was around 14-16 percent in that period. When we consider the term deposit interest rates of commercial banks as the opportunity of the LPDs, this number implies that the LPDs have been sustainable according to the definition of microfinance sustainability (Yaron 1994).

However, in a comparative context, this figure is slightly lower than the ROE of the LPDs at the provincial level of 54.2 percent calculated by Chaves and Gonzales-Vega (1995), but it is still higher than the calculation of Christen *et al* (1995) of 32.7 percent per annum. This difference might be caused by a different method of calculation and time period. Compared to the ROE of BKK at 13 percent (Yaron 1992) which has similar characteristics with LPDs, the figure is much higher.

In sum, the growth of the two profitability indicators (ROA and ROE) shows that the LPDs have been able to perform as a profitable and sustainable microfinance institution. Three internal factors might have produced this high profitability rate. First, the high level of efficiency of the LPDs, as discussed earlier, obviously contributed to

this high profitability. Second, the high growth of clients' deposits (savings and term deposits), accompanied by the high growth of loans disbursed, also plays a role in the profitability of the LPDs. Even though the high growth of clients' deposits has resulted in a high DER, the LPDs were able to on-lend the deposits to clients and generate income. In addition, as noted in section 6.3 in Chapter 6, when the LPDs experience excess liquidity they have to deposit their excess funds with the Bank BPD Bali and receive a competitive interest rate. Third, the high repayment rate of the LPDs greatly contributed to their high profitability. This high repayment rate maintains the liquidity of the LPDs and sustains their ability to on-lend the generated funds to clients. Finally, the external factor that has supported the LPDs to gain high profitability is the macroeconomic environment. The stable and growing macroeconomic condition of Gianyar district, as discussed earlier, has enabled the LPDs to attain their high profitability rate.

Financial viability refers to the ability of the LPD to cover its costs with earned revenue. The two indicators of financial viability used are operational self-sufficiency and financial self-sufficiency (Ledgerwood 1999). Operational self-sufficiency indicates the ability of LPDs to earn enough revenue to cover direct costs, excluding the (adjusted) cost of capital but including actual financing costs incurred. Financial self-sufficiency indicates the ability of LPDs to earn enough revenue to cover both direct costs, including financing costs, provision for loan losses, operating expenses, and indirect costs, including the adjusted cost of capital. In this study, the adjusted cost of capital is considered to be the cost of maintaining the value of equity relative to inflation. The indicators of financial viability are also presented in Table 7.7.

The level of financial viability of the LPDs shows an increasing trend. In 1999 and 2001, the level was 199 percent and 196 percent respectively, whereas the level of financial self-sufficiency was 181 percent and 163 percent. These levels of self-sufficiency are higher than those of Christen *et al* (1995), which were 148 percent and 137 percent for operational and financial self-sufficiency respectively. Combined with other financial indicators discussed above, the increasing trend of operational and

financial self-sufficiency evidently indicates that the LPDs are financially viable, which is one of the necessary conditions for a sustainable microfinance institution.

There are three internal interrelated factors explaining this high financial viability; high profitability, high efficiency, and good portfolio quality or high repayment rate. As discussed above, the high level of efficiency of LPDs has resulted in their high profitability. In literature, it is argued that the efficiency and profitability are the main factors shaping the self-sufficiency of microfinance institutions (Ledgerwood 1999, p.217). More specifically, Christen *et al* (1995) argue that levels of self-sufficiency have been very much affected by the effective real interest rate charged by a microfinance institution which, in turn, affects the profitability of the institution. As mentioned in Chapter 6, the LPDs charge an interest rate of around 0.8-1.3 percent monthly for savings (and term deposits) and 2.25-2.75 percent monthly lending rate. These figures show that the LPDs have set up an effective real rate of interest high enough to cover their costs, including the cost of capital fully adjusted for inflation. Lastly, good portfolio quality or high repayment rate has contributed to their self-sufficiency, both directly through its effect on the profitability and indirectly through its effect on the liquidity and net income of LPDs. As noted earlier, attaining a high repayment rate is a necessary condition for a microfinance institution to become self-sustainable in the long run.

Comparing the profitability and financial viability of the LPDs located in handicraft and agriculture based sub-districts, it is evident that profitability and financial viability of both regions are not different statistically as shown in Table 7.8. Theoretically, profitability of a microfinance institution is greatly affected by its portfolio quality (the repayment rate) since the portfolio quality will affect its net income; and the financial viability (operational and financial self-sufficiency) of a microfinance institution is highly influenced by its efficiency and profitability (Ledgerwood 1999, p.221-223). In the case of LPD, as discussed above, the portfolio qualities of LPDs located in those two different regions are not different statistically, and consequently their profitability is assured in each of the regions. In regard to financial viability (operational and

financial self-sufficiency), there is no difference between the two regions. This is due to the efficiency and profitability of LPDs in each region being the same. This condition indicates that the LPDs located in agricultural sub-districts can be as sustainable as their sister institutions in handicraft sub-districts, despite the fact that predominantly agricultural areas in Bali tend to economically less dynamic. In short, the economic base of the regions does not affect the sustainability of the LPDs. This means that the sustainability of the LPDs are affected by other factors such as a stable macroeconomic environment, the practical arrangement of the LPDs based on the informal institutions (custom regulation) of the Balinese including social norms, sanctions, and involvement of the custom village leader in the screening process and contractual enforcement of loans, and regulations set up by the Central Bank (formal institutions) as discussed in Chapter 6.

Table 7.8 Arithmetic Means and Results of the Mann-Whitney Tests for Profitability and Financial Viability between Two Groups of LPDs, 2001

Indicators	2001			
	Handicraft industry based sub-districts	Agricultural based sub-districts	two-tailed p-value*	The Mann-Whitney test results
Profitability:				
▪ Return on Asset (ROA) in %	13 (n=91)	13 (62)	0.45	No difference
▪ Return on Equity adjusted (ROE) in %	164 (n=44)	73 (22)	0.92	No difference
Financial viability:				
▪ Operational self-sufficiency (%)	94 (n=44)	89 (n=22)	0.73	No difference
▪ Financial self-sufficiency (%)	85 (n=44)	85 (n=22)	0.88	No difference

Note: * Critical p-value is 0.05 (p-value<0.05 means difference, otherwise).
Source : PLPDK, *Financial Report of LPD Gianyar District of Bali Province*, 2001 (computed by the author).

7.7 OUTREACH

Some scholars (Yaron 1994; Yaron, Benjamin et al. 1997; Schreiner 2001) point out that outreach indicators could be used as indicators of the impact of microfinance institutions on economic development. They argue that even though the indicators do not provide a full assessment of a microfinance institutions impact on economic development, they serve as quantifiable proxies of the extent to which a microfinance institution has reached its objectives of providing social benefits for poor people. Hence, the outreach indicators have to be considered in the context of the objectives of microfinance institutions, which define its target clientele. These indicators are classified into three groups: client and staff, loan, and savings/deposit outreach (Table 7.9).

As shown in Table 7.9, the LPDs experienced an increasing trend for almost all outreach indicators, except average depositor per LPD. The scale of outreach, for instance, measured by the number of clients served and the volume of outstanding loans and savings, has grown significantly over the period 1999 to 2001. In 1999, the total number of borrowers was 36,454 while the total number of savers and depositors was 87,998 and these figures increased to 49,593 and 122,942 respectively in 2001. Along with client growth, the volume of outstanding loans also increased almost 1.5 times from Rp36 billion in 1999 to Rp89 billion in 2001. Meanwhile, the volume of savings and term deposits increased more than 100 percent from Rp44.5 billion in 1999 to Rp96 billion in 2001.

The figures below show that the total clientele served in terms of savers and depositors was higher than the total clientele served in terms of borrowers and, the volume of loan outstanding was lower than the volume of total savings and term deposits. There are two important things worth noting from these figures. First, the figures indicate that the LPDs have succeeded in stimulating and enhancing the savings behaviour of rural people. In addition, this situation shows that the LPDs have achieved one of their objectives, which is to increase the banking mindedness of rural people and the degree of monetisation in rural areas in general (Government of Bali 2002). Second, the

figures also indicate that the LPDs have succeeded in offering an appropriate mechanism in mobilising savings such as the mobile banking system, interest rates, and other incentives for savers and potential savers. The LPDs clients (Rempun, Kelin, and Warsha, interviews on 22 and 23 February 2002) point out that the LPDs delivery mechanisms meet their needs. Moreover, as discussed in Chapter 6, this situation also implies that the clients' confidence in the LPDs is high, since savings security is an important consideration for the clients in making a decision to save or not to save in any financial institution.

Table 7.9 Outreach of LPDs within Gianyar District of Bali Province, 1999 and 2001

Indicators	1999	2001
Clients and Staff outreach:		
▪ Number of borrowers	36,454	49,593
▪ Average borrowers per LPD	309	324
▪ Number of savers	81,178	114,994
▪ Average savers per LPD	695	751
▪ Number of deposit accounts (depositors)	6820	7948
▪ Average depositor per LPD	60	52
▪ Number of staff	723	835
▪ Average number of staff per LPD	n.a	5
▪ Percentage of total target clientele serviced (%)	10.3	13.4
Loan outreach:		
▪ Volume of outstanding loans (billion Rp)	36	89
▪ Average outstanding loan per LPD (million Rp)	308	587
▪ Average loans per borrower (million Rp)	0.9	1.6
▪ Average loans per borrower as percentage of GRDP per capita[1)]	0.21	0.27
Saving/Deposits outreach:		
▪ Volume of savings (billion Rp)	22.5	50
▪ Average savings per LPD (million Rp)	198	327
▪ Average savings per saver as proportion of GRDP/capita[1)]	0.05	0.07
▪ Volume of time deposits (billion Rp)	22	46
▪ Average deposits per LPD ((million Rp)	221	335
▪ Average deposit per depositor as proportion of GRDP/capita[1)]	0.7	0.9

Note: [1)] Based on GRDP per capita of Gianyar district at current price in 1999 and 2001 were Rp 4.6 illion and Rp 5.8 million respectively.

Source : PLPDK, *Financial Report of LPD Gianyar District of Bali Province*, 1999 and 2001 (computed by the author).

This finding confirms those of other studies (Kelley and Williamson 1968; Adams 1978; Robinson 1994) which reveal that rural people - including households, small-scale enterprises, organisations - will save in a financial form if appropriate institutions are offering security, convenience, liquidity, and returns on savings. The ability of microfinance institutions - the LPDs in this case - to meet the needs of the local people that they are designed to help will, in turn, be one of the advantages of the LPDs to be a sustainable microfinance institution (Snow 1999, p.66). From an institutional point of view, as noted in Chapter 2, incorporating savings mobilisation in microfinance institutions will have at least three benefits for the institutions (Robinson 1995). First, it can provide a relatively inexpensive source of capital for re-lending. Second, today's depositors may be tomorrow's borrowers, so the savings program creates a natural client pool. Third, building up savings may offer important advantages to low-income households directly: households can build up assets to use as collateral, they can build up a reserve to reduce consumption volatility over time, and they may be able to self-finance investments rather than always turning to creditors.

The depth of outreach is shown by target clientele (borrowers) serviced, average loan/savings/time deposits per borrower, and the ratio of the average loans per borrower, average savings per saver, and average time deposits per depositor to GRDP per capita. The depth of outreach indicators reflect the value that society attaches to the net gain of a given client (Schreiner 2002, p.594).

The data in the table reveal that target clientele served has increased from 10.3 percent in 1999 to 13.4 percent in 2001. Along with the increase in the target client served, the average loan per LPD has also increased from Rp308 million in 1999 to Rp587 million in 2001 and the average savings and term deposits per LPD increased from Rp198 million and Rp221 million in 1999 to Rp327 million and Rp335 million in 2001. These figures reflect that the LPDs have also reached one of its objectives, that is, to support rural economic development through providing credit to local people.

The ratio of the average loans per borrower, average savings per saver, and average term deposits per depositor to GRDP per capita have also increased along with the increase of their percentages of GRDP per capita. These figures indicate that both the economic capacity and banking mindedness of the clients and financial capability of LPDs in providing financial services have also increased in line with the growth of GRDP per capita (economic growth) in the Gianyar district of Bali. In other words, the figures also indicate that the LPDs have yielded social benefits for their clients.

Referring to the objectives of LPDs, all of these figures indicate that the LPDs have been able to achieve their objectives, which are to support rural economic development through enhancing the savings behaviour of rural people and providing credit for local people, to create an equal opportunity for business activities at the village level, and to increase the degree of monetisation in rural areas. Hence, it can be argued that the LPDs have played an important role in rural economic development in the Gianyar district. According to Bali Province Regulation No. 2/1988 and No. 8/2002 the LPDs has no poverty reduction objective and in line with that this study does not investigate the impact of the LPDs on poverty alleviation.

Table 7.10 A Comparison of Some Outreach Indicators between Two Groups of LPDs, 2001

Indicators	2001	
	Handicraft industry based sub-districts	Agricultural based sub-districts
Clients and Staff outreach:		
▪ Number of borrowers	30,232	19,361
▪ Number of savers	81,321	33,673
▪ Number of depositors	5179	2769
▪ Number of staff (employee)	543	292
▪ Percentage of total target clientele serviced (%)	12.5	15.4
Loan outreach:		
▪ Total outstanding loans (billion Rp)	69	21
▪ Average loan per borrower as percentage of GRDP per capita	0.3	0.18
Saving/Deposits outreach:		
▪ Volume of savings (billion Rp)	39.6	10.5
▪ Volume of time deposits (billion Rp)	36	10.9

Source : PLPDK, *Financial Report of LPD Gianyar District of Bali Province*, 2001 (computed by the author).

In sum, the growth of the outreach indicators of LPDs indicates that the LPDs have yielded social benefits for their clients. There are four factors shaping the growth described above. First, the ability of LPDs management to offer appropriate delivery mechanisms that meet and suit to the needs of the local people. Second, an increasing number of staff and their productivity also contributes to this growth. Third, the social ties of LPDs to clients in a custom village that share social and religious norms, as discussed in Chapters 4 and 6, has encouraged high client reliance and loyalty (sense of belonging) on the LPDs and, in turn, influenced the outreach of LPDs. Finally, the growing macroeconomic condition of Gianyar district has also contributed to the growth of outreach of the LPDs. As discussed earlier, it is argued that a growing economy has resulted in high and growing demands for financial services offered by financial institutions, such as LPDs, that in turn affect its outreach.

Table 7.11 Arithmetic Means and the Results of the Mann-Whitney Test for the Outreach between Two Groups of LPDs, 2001

Indicators	2001			
	Handicraft industry based sub-districts	Agricultural based sub-districts	two-tailed p-value*	The Mann-Whitney test results

Clients and Staff outreach:				
▪ Borrowers	332	312	0.44	No difference
▪ Savers	893	543	0.03	Difference
▪ Depositors	56	44	0.21	No difference
▪ Staff	6	4	0.01	Difference
Loan outreach:				
▪ Loan outstanding per LPD (million Rp)	751	346	0.00	Difference
▪ Loan per borrower (million Rp)	1.9	1	0.00	Difference
Saving/Deposits outreach:				
▪ Savings per LPD (million Rp)	435.5	169.6	0.00	Difference
▪ Savings per saver (million Rp)	0.48	0.32	0.00	Difference
▪ Deposits per LPD ((million Rp)	433.8	191.8	0.00	Difference
▪ Deposits per depositor (million Rp)	6.4	4.6	0.00	Difference

Note: * Critical p-value is 0.05 (p-value<0.05 means difference, otherwise).

Source : PLPDK, *Financial Report of LPD Gianyar District of Bali Province*, 2001 (computed by the author).

Tables 7.10 and 7.11 illustrate the comparison and the Mann-Whitney test of outreach indicators between LPDs in handicraft-based and agricultural-based regions. In terms of the scale of outreach, the data show that most outreach indicators - such as number of borrowers, savers, depositors, total and average outstanding loans, total and average savings and depositors - in the handicraft-based sub-districts are higher that those in the agricultural regions and statistically significant. This implies that the economic base of a region significantly affects the outreach of the LPDs. In this case, it is obviously shown that the region (handicraft-based sub-districts) with higher GRDP per capita and number of population[66] also has a higher outreach. However, when looking at the percentage of the total target clientele serviced, the LPDs located in the agricultural-based sub-districts have a higher number. This is mainly because the population in

[66] see Table 5.1 in Chapter 5

agricultural-based sub-districts (125,391) is much smaller than that of the handicraft-based sub-districts (242,412).

7.8 FACTORS AFFECTING REPAYMENT RATE: A LOGISTIC ANALYSIS

A direct logistic regression analysis was performed on the repayment rate and six predictors: outstanding loans, number of borrowers, number of savers, number of staff, wealth index, and dummy variable for regions. Analysis was performed using SPSS LOGIT. After deletion of two cases of missing values, data from 152 LPDs were available for analysis: 88 LPDs with the repayment rates (RR) above the average RR of its population rate and 64 LPDs with below the average RR of its population rate.

The first step in any regression analysis is to ask if the predictors, as a group, contribute to the prediction of the outcome. In logistic regression, this is the comparison of the constant-only model with the constant plus all predictors model. The test results[67] of the full model with all six predictors against a constant-only model using the Hosmer and Lemeshow test was statistically reliable, $\chi^2(8, N = 152) = 18.36$, $p<0.05$ (p-calculated = .019). This indicates that the predictors, as a set, reliably predict the repayment rate for the LPDs. Moreover, this result also indicates that there is no multicollinearity problem (Tabachnick and Fidell 2001).

The strength of the relationship between the dependent variable and the independent variables - analogous to the R^2 measures in multiple regression – is shown by the Cox and Snell R^2 and the Nagelkerke R^2 with higher values indicating greater model fit (Tabachnick and Fidell 2001, p.545). Both R^2 are low, the Cox and Snell R^2 is only 0.063 and the Nagelkerke R^2 is only 0.08. These figures indicate only around six to eight percent of shared variance between the repayment rate and the set of predictors. Hence, the gain in prediction is minimal. The model prediction success confirms the ability of the model in predicting the repayment rate is not high, even if the predictors

[67] The computer results of the logistic model are presented in Appendix 9

in the model are significant. The overall success rate was 65 percent (the cut off value is 50 percent), with 84 percent of the LPDs with the RR above average and 39 percent of the LPDs with the RR below average correctly predicted. This result also indicates that the predictors, as a set, reliably distinguish between the repayment rate of the LPDs with a repayment rate above average and the LPDs with repayment rate below average.

According to the Wald criterion, there are no statistically significant predictors influencing the repayment rate. Table 7.12 shows regression coefficients and the Wald test for each of the coefficients. The signs for the four regression coefficients are as expected, but two other coefficients are not. These results are discussed below.

Table 7.12 Logistic Regression Analysis of the Repayment Rate

Variables	Coefficients	Wald test	Significance (p-value)*
1. Outstanding loans	.000	.084	.772
2. Number of borrowers	.000	.053	.818
3. Number of savers	-.001	2.646	.104
4. Number of staff	.004	.001	.972
5. Wealth index	.070	.034	.853
6. Dummy regions	.303	.594	.441
7. Constant	.143	.066	.797

Note: * Critical p-value is 0.05 (p-value<0.05 means significant, otherwise).

In Chapter 5, outstanding loans were hypothesised to have a positive effect on the repayment rate. However, the regression coefficient of outstanding loans (OUTSTL) is insignificant (p-value>0.05). This means that the outstanding loans do not influence the repayment rate. The hypothesis that the greater the loan size, the greater the probability of unwilling default (greater repayment rate) or the greater loan size puts pressure on the borrower to reduce delinquency, is not proven. Therefore, the outstanding loans neither improve nor worsen the repayment rate in this case. The finding concurs with Sharma and Zeller's (1997) study of microfinance institutions (ASA, BRAC, and RDRS) in Bangladesh (Sharma and Zeller 1997).

The number of savers and the value of savings reflect the financial discipline of the clients of a microfinance institution, as has been outlined in Chapter 5. These factors could be expected to increase the repayment rate or to maintain a high repayment rate. However, the regression coefficient of the number of savers (NUMSAVR) is insignificant. This means that the number of savers does not influence their repayment rate. The result implies that the influence of the savers in improving the repayment rate is not significant. On the other hand, however, this result indicates that the financial discipline of the clients of LPDs is high, as shown by their high repayment rates discussed earlier. Hence, regardless of the provision of the savings service, the repayment rate of the LPDs remains high. Referring to the findings in Chapter 6, this situation might be affected by the effectiveness of social sanctions (written in the custom village regulation or *awig-awig*) in enforcing contractual agreements between the LPDs and their clients.

The regression coefficient of number of borrowers (BORROWERS) is insignificant i.e. the number of borrowers does not influence the repayment rate. The hypothesis that the larger number of borrower could cause imperfect information problems (monitoring and enforcing problem) that would in turn affect the repayment rate, is not evident in this study. As discussed in Chapter 6, the LPDs have an intimate knowledge of their clients and rely on mechanisms of social control in screening and enforcement problems based on the shared social and religious norms of the custom village. As a result, client information is easily available which could eliminate the asymmetric information and adverse selection problems as a key problem affecting the likelihood of default of microfinance institution. The study by Sharma and Zeller (1997) also reveals that the number of borrowers per staff does not affect the repayment rate of microfinance institutions in Bangladesh.

As is hypothesised earlier, the larger the number of staff, the higher the repayment rate, since a larger number of staff means there is a higher capability to monitor and manage clients. In this study, however, the number of staff does not have any influence on the repayment rate which is shown by the insignificant regression coefficient

(NUMSTAF). This implies that the number of current staff has been quite enough to manage the LPDs. With the ratio of 67 borrowers per staff in 2001, the LPDs are still able to maintain their high repayment rates.

Two dummy variables, WEALTH and REGION, do not have a significant effect on the repayment rate either. The regression coefficient of WEALTH1 and WEALTH2 – control for GRDP per capita of sub-district – is insignificant. This means that the wealth of the clients does not influence their repayment rate. The results show that the wealthier clients (handicraft sub-districts) do not repay their debt any better than the poorer ones (agricultural sub-districts). Hence, in other words, the wealth of group members does not improve the repayment rate, and the capacity to repay does not matter in the actual repayment performance in the case of LPDs. Theoretically, the repayment rate is a function of both capacity and willingness to repay (Norell 2001 p.128).[68] Accordingly, this implies that willingness to repay is the most important factor affecting the high repayment rate to LPDs. Again, referring to the findings in Chapter 6, this good willingness to repay might result from the effectiveness of social sanctions in enforcing contractual agreement between the LPDs and their clients.

The regression coefficient of dummy variable REGION1 and REGION2 - control for socio-economic conditions that may influence the repayment rate – is not significant, meaning that the type of regions (handicraft based sub-districts or agricultural based sub-districts) has no influence on the repayment rate of the LPDs. This result confirms the result of the Mann-Whitney test conducted previously. Hence, it can be concluded that the repayment rate of the LPDs in Gianyar district is not influenced by the socio-economic base conditions of the regions. Then it could be argued that the repayment rate of LPDs is directly affected by the practical arrangements of LPD management using custom regulation including social norms, sanctions, and involvement of custom village leader in the screening process and contractual enforcement of loans (informal

[68] In respect to capacity and willingness to repay, Norell (2001) classifies four types of clients: willing and able to repay, willing but unable to repay, unwilling but able to repay, and unwilling and unable to repay.

institutions), and indirectly affected regulations set up by the Central Bank (formal institutions). This finding is consistent with the finding in section 7.4.

The insignificancy of all predictors in the model leads to the question of what factors do influence the repayment rate. Referring to the previous discussion in Chapter 2, Chapter 4, Chapter 6, and section 7.4, this condition indicates that informal institutions – such as custom regulation (social norms and sanctions), social cohesion, and the use of social mechanism in screening the credit applicants and enforcing the repayment through involvement of the custom leader – have played a significant role in enforcing the willingness to repay of the clients that, in turn, result in the high repayment rate of the LPDs.

As has been discussed, the non-market institutions (informal institutions) tend to exploit a comparative advantage in monitoring and enforcement capacity (Arnott and Stiglitz 1990; Stiglitz 1990; Fuentes 1996). The primary advantage of the LPDs - as a local institution - in terms of monitoring is that individuals who interact in a variety of non-market contexts tend to know each other well. They therefore may have a greater ability to monitor each other than do commercial banks. In this respect, the character-based lending system has been applied appropriately and effectively by the LPDs through social mechanism.

This finding conforms to Chaves and Gonzales-Vega's (1995) argument that social pressure from local tradition is one of the important factors affecting compliance of microfinance clients in the rural areas of Indonesia. Hence, it could be inferred that the high repayment rate of the LPDs in the Gianyar district of Bali has been strongly influenced by the informal institutions.

7.9 SUMMARY

Based on the performance indicators - portfolio quality, leverage, capital adequacy ratio (CAR), productivity, efficiency, profitability, self-sufficiency, and outreach – the

LPDs in Gianyar district could be considered as successful microfinance institutions. Compared to other microfinance institutions in Indonesia, the LPDs have performed better according to key performance indicators. In respect to the analysis of the different performance between LPDs located in handicraft based sub-districts and agricultural sub-districts, the evidence reveals that most of the performance indicators - especially financial indicators - are the same between the two different groups. However, most of the outreach indicators are different between the two groups of LPDs. But this difference does not mean that the LPDs located in the handicraft based sub-district have a greater positive impact on the target clientele. They differ because the types of business activities of the majority of clients, the size of the population, and the level of per capita income (GRDP) of the clients in the two LPDs are also different. Analysis of the repayment rate using the quantitative approach (logistic model) combined with the findings using the institutional approach in Chapter 6 indicate that the Balinese social custom and traits, including social values, norms, and sanctions (informal institutions) have a significant influence in sustaining the high repayment rate of the LPDs.

The good performance of the LPDs in Gianyar district could be explained by some important factors. First, a growing economy and supporting government policy at all levels through provision of a legal basis for the LPDs and the Central Bank regulation – the so-called formal institutions - as discussed in Chapter 6 have also contributed to the success of the LPDs. The two factors offer an auspicious climate for the LPDs to develop and perform well.

The second factor is the use of local people in managing the LPD and the application of a character-based lending system in credit delivery. As discussed earlier, the LPDs are community financial institutions which are owned, managed, and used by the members of a custom village. This has resulted in a high clients' sense of belonging and moral obligation to support the development of the LPD. Third, the use of social (custom) sanctions in the contractual enforcement has forced the borrowers to comply with their credit contract in a timely fashion. In addition, the use of a mobile banking technique

for collecting savings deposits and loan repayments directly has also compelled the clients to repay their loans regularly and timely.

Fourth, the use of local community personnel whose remuneration is based on performance and low transaction costs has resulted in the high efficiency of LPDs. This high efficiency has fostered the high profitability and self-sufficiency of LPDs. Lastly, the high outreach level accompanied by high client loyalty has a positive impact on the sustainability of the LPDs. As argued by Christen (1998), one of the most important factors affecting the self-sustainability of microfinance institutions is a high level of outreach.

Finally, based on the necessary conditions of sustainable microfinance institution proposed by some scholars (Yaron 1994; Christen 1998), it can be concluded that the Gianyar district LPDs have been sustainable. This also implies that the LPDs have positive net social benefits for their clients. As argued by some scholars (Ostrom, Schroeder et al. 1993, p.13-14), when a microfinance institution becomes sustainable, net social benefits will be positive. Hence, the positive impact of the LPDs on their target clientele indicates that their role as a development tool has been evident in the economic development of Gianyar district.

In sum, the findings in this chapter reveal the important role of the institutional environment on the sustainability of microfinance institutions. These findings reinforce the findings in Chapter 6, that is, the institutional environment has played a significant role on the practical arrangement of microfinance institutions in Bali. Practically, however, any attempt to replicate the achievements of the LPDs by imitating its mode of operations should be conducted with great caution. A mechanism that works well in one socioeconomic environment (in this instance, in Bali) will not necessarily work in another, where the social system including social norms and values are different. However, the experience of the LPDs has highlighted some critical issues that should be considered when handling the complex issue providing financial services to rural people.

CHAPTER EIGHT

CREATING ELEMENTS OF A STRATEGIC BUSINESS PLAN FOR LPD MAS OF UBUD AND LPD KERTA OF PAYANGAN, GIANYAR DISTRICT, BALI

8.1 INTRODUCTION

This chapter is the last part of the analysis. The analysis in this chapter is the consequence of the use of the embedded case study design adopted in this study. After analysing the Village Credit Institutions (*Lembaga Perkreditan Desa* or LPD) at the provincial and district level using aggregate data (consolidated financial data at provincial and district level), this chapter presents an analysis of a single unit of LPD. This chapter attempts to outline elements of business plans for two LPDs, Mas of Ubud, located in handicraft-based sub-district, and Kerta of Payangan, located in an agricultural-based sub-district. In preparing the plan, a SWOT (Strengths, Weaknesses, Opportunities and Threats) analysis was prepared based on the methodology outlined in Chapter 5. The use of SWOT analysis is part of the methodological triangulation used in this study, following the qualitative (descriptive) and quantitative analysis in Chapters 6 and 7, respectively.

As stated in Chapter 5, strategic planning refers to a process of discovery and awareness creation as environmental (market place) changes are identified and related to relevant enterprise strengths and weaknesses (Flavel and Williams 1996; Thompson and Strickland III 2001; Pearce II and Robinson 2003; Kuratko and Hodgetts 2004). It includes defining the enterprise's mission, specifying achievable objectives, and developing strategies. A strategic business plan refers to a written, long-range plan with

the inclusion of a mission statement, organisation objectives and strategies to enable accomplishment of the objectives (Flavel and Williams 1996, p.4; Thompson and Strickland III 2001, p.17). The aim of creating a strategic business plan is to improve on how an enterprise is operating today and to identify the actions required to prepare for future markets and changing environment conditions (Flavel and Williams 1996; Thompson and Strickland III 2001; Pearce II and Robinson 2003; Kuratko and Hodgetts 2004). The formulation of some recommended strategies or creation of some elements of a business plan in this study is expected to have some benefits for the future development of the LPD unit being studied.

8.2 SWOT ANALYSIS OF LPD MAS OF UBUD, GIANYAR, BALI

As a result of some development constraints associated with the LPD Mas of Ubud in the future, it is necessary to outline some elements of a business plan for the LPD. The first step involved is conducting a SWOT analysis. Following the completion of the SWOT, the following steps were undertaken: development of a mission statement, identification of objectives to allow the vision of the enterprise to be achieved, and formulation of strategies designed to achieve the objectives.

LPD Mas was established in 1985 to support the rural economic development of Mas custom village. It is located in Ubud, a handicraft industry based sub-district, in Gianyar district of Bali province. It was established based on the Bali Governor's Decree No.495/1985. In 2001, LPD Mas had total assets of Rp7055 million, total equity of Rp373.4 million, bank deposits in Bank BPD Bali of Rp1560 million, and profit of Rp427.9 million and served 1607 borrowers, 5377 savers, and 513 depositors (see Tables 1 and 2 in Appendix 10). It has the motto 'Bersama Anda Membangun Desa', which means (more or less) 'We develop our village together'.

The internal strengths and weaknesses and the external opportunities and threats of the LPD Mas were mainly identified from consultations and discussions with the owners, managers, members of Commissioner Board, and other stakeholders involved, such as

the local government (provincial and district level) of Bali and Bank BPD Bali. The institutional analysis in Chapter 6, performance analysis in Chapter 7, and some indicators of LPD Mas in Appendix 10 are also used as a basis for this analysis. Following the methodology of categorising, scoring, and weighting scores (Flavel and William 1996), the key elements are identified in the SWOT analysis in Table 8.1 is based on diagnostic checklist in Appendix 11. A summary of key findings from the analysis follows.

Summary of main strengths

There are some strengths of LPD Mas based on its internal management. First, the strength of its planning and organising. This strength has been one of the factors affecting its sustainability since its establishment in 1985. The strengths are reflected by the establishment and operating of LPD Mas which has been supported by some institutions (such as local government at all levels, Bank BPD Bali, and custom village) through their involvement in supervision and guidance, its simple organisational structure that caused a manageable span of control, a clear and clarified job description, and the well-distributed responsibilities of each unit. All of these factors will be significant advantages in the future development and operation of the LPD Mas.

Secondly, its recruitment procedure, remuneration system, staff motivation and productivity indicate the strengths of LPD Mas in terms of personnel management. The core management committee of LPD Mas are selected from the community members (*krama desa*) of the Mas custom village and elected during village meetings (*paruman desa*), mainly based on the character of the committee candidates. LPD Mas has applied a remuneration system which is called a management compensation scheme based on performance. It consists of a combination of a fixed salary and a bonus or incentive payment that is a function of some observable and measurable variables, including profits or loan instalments recovered. The fixed or basic salary is based on the cost of living where the LPD is located. This remuneration system has the advantage of being fair and accountable. The satisfaction of the staff with the

remuneration system of LPD Mas is indicated by the high level of work motivation reflected by a zero absence rate of the staff and a low staff turn over.

Thirdly, LPD Mas also has some strengths in its financial management and performance. It has applied standardised financial reporting (monthly and annually) and budget preparation systems (annually) set up by Bank BPD Bali. In addition, in terms of financial indicators - such as the growth of assets and equity, efficiency, and profitability – LPD Mas has been performing well (see Appendix 10).

Lastly, LPD Mas also has some strengths with regard to its marketing management. It offers financial services which are mainly loans, savings, and deposits. In its delivery mechanism, the LPD applies a simple and flexible credit and savings mechanism to suit its specific clientele in the rural area. LPD Mas has applied the character-based lending approach which is considered as a very advantageous and cheap technique in the literature (Chaves and Gonzales-Vega 1996). Although its lending rate has been relatively highe compared with the average commercial bank interest rate, LPD Mas offers additional services to their clients such as a simpler and easier loan mechanism procedure, faster disbursement and collateral free for small loans of less than Rp500 thousand.

Since one of the key factors of sustainability of microfinance institution is its ability to mobilise savings, LPD Mas has also been attempting to enhance its clients' savings. Most of its clients' savings is collected through mobile services. An LPD Mas staff member visits the clients weekly, usually on market day, collecting savings deposits and loan repayments. In the literature the advantage of this practice is that it can reduce transaction costs for both the clients and the microfinance institution itself. Moreover, this procedure could also be expected to increase the loan repayment rate through the increase of financial disciplines on the clients.

LPD Mas has also conducted promotion strategies to penetrate the local market and to foster loyalty in its clients.[69] The strategies include presenting gifts and scholarships to primary and secondary school students who have outstanding achievements, donating funds for *pura* (temple) construction projects, donating for *banjar* (hamlet) religious ceremonies and maintaining roads, and distributing stickers to its clients. The Chairperson states that to date LPD Mas has given scholarships to 16 secondary school students.

Summary of main weaknesses

The management of LPD Mas also has some weaknesses. Even though it has been established since 1985, LPD Mas has no formal research and development program and no promotions and staff development system. In a changing socio-economic environment, a research and development program is a necessity in order to keep the competitive advantage of the organisation. A promotions and staff development system might also be needed to stimulate the motivation of the staff.

In addition, the LPD Mas suffers from inadequate training programs and equipment. At present the LPD has no regular program for training staff. Training - both in general management and in specific areas of management such as risk and banking management – is rarely conducted. The office equipment of the LPD, which only has 3 computer units, is relatively limited for eleven staff.

Summary of opportunities

LPD Mas has a strong opportunity to develop more in future based on its access to market, its pricing policy, quality of services, clients' loyalty, inferior quality of its competitors, and its employment source. It has a very good access to its market since it serves the local community (custom village). With the good quality of its services, as outlined in the strengths summary above, accompanied by its competitive pricing policy especially the savings interest rate, LPD Mas will be able to develop its clients'

[69] The data on the growth of its clients, loans, and savings is presented in Appendix 10.

loyalty and compete with its competitors. Moreover, the LPD also has an opportunity to diversify its business activities which, in turn, would broaden employment opportunities for the community members of the custom village.

Summary of threats

The main threat to LPD Mas would be the change in social attitudes of its society, since the establishment, operation, and effectiveness of this institution is mainly based on the social custom of the Balinese population. If the social custom changes because of expanded market transactions and a more diversified society, the changes could have a negative influence on LPD Mas, especially the compliance of its clients. Other potential threats would be unstable and stagnant economic conditions, competitors, and changing regulations. LPD Mas needs a stable and growing economic condition to maintain its sustainability as a microfinance institution. The competition is low since the competitors are few. However, changing client tastes and needs may also be a factor which will need attention, perhaps by diversification of financial services. Changing government regulations could be also be a threat for LPD Mas in the future, particularly when the changes cause macroeconomic instability and uncertainty. However, so far most regulations concerning microfinance institutions are suited to LPD Mas.

Table 8.1 SWOT Analysis
Table LPD Mas of Ubud,
Gianyar, Bali

		Score	Average percent	Weight	Sub-Total
1	STRENGTHS				
1.1	**Organisation arrangements**		**80.8**	**0.25**	**20.2**
	▪ **Planning and organising**	**80**			
	▪ **Relationship between the LPD management, Board of Commissioner, Supervisory Board, and other stakeholders**	**90**			
	▪ **Size of operation**	**80**			
	▪ **Location of operation**	**90**			
	▪ **Access to general staff**	**85**			
	▪ **Access to specialised staff**	**60**			

		Score	Average percent	Weight	Sub-Total
1.2	**Personnel aspect**		**83.7**	**0.20**	**16.7**
	▪ **Recruitment procedure**	**85**			
	▪ **Remuneration system**	**80**			
	▪ **Motivation of staff**	**85**			
	▪ **Productivity of staff**	**85**			
1.3	**Financial aspect**		**84**	**0.25**	**21**
	▪ **Financial reporting**	**75**			
	▪ **Budget preparation**	**75**			
	▪ **Operational cost**	**90**			
	▪ **Return on Assets**	**90**			
	▪ **Operational self-sufficiency**	**90**			
1.4	**Marketing aspect**		**83.3**	**0.20**	**16.6**
	▪ **Marketing strategies**	**80**			
	▪ **Financial services designs**	**85**			
	▪ **Delivery mechanism**	**80**			
	▪ **Pricing policy**	**85**			
	▪ **Promotion activities**	**80**			
	▪ **Sales trends**	**90**			
1.5	**Infrastructure/equipment**		**71.2**	**0.10**	**7.1**
	▪ **Vehicles**	**75**			
	▪ **Computer/printer**	**65**			
	▪ **Typing machine**	**75**			
	▪ **Office equipments**	**70**			
	Sub-total				**81.8**
2	WEAKNESSES				
2.1	**Organisational arrangements**		**55**	**0.40**	**22**
	▪ **Lack of a mission statement**	**55**			
	▪ **Lack of research and development program**	**50**			
	▪ **Lack of promotion & staff development system**	**60**			
2.2	**Skills of staff**		**55**	**0.40**	**22**
	▪ **Inadequate training in general management**	**50**			
	▪ **Inadequate training in specific area such as financial management and banking management**	**60**			
2.3	**Equipment**		**57.5**	**0.20**	**11.5**
	▪ **Quality of computers equipment**	**55**			
	▪ **Quantity of computers equipment**	**60**			

		Score	Average percent	Weight	Sub-Total
	Sub-total				**55.5**
3	OPPORTUNITIES				
3.1	**Access to markets**		**85**	**0.30**	**25.5**
	▪ **Serve local community**	**85**			
	▪ **Competitive pricing policies**	**85**			
	▪ **Opportunities to diversify business unit**	**85**			
3.2	**Marketing**		**81.6**	**0.40**	**32.6**
	▪ **Quality of services**	**80**			
	▪ **Inferior quality of competitors services**	**75**			
	▪ **Clients loyalty**	**90**			
3.3	**Employment**		**80**	**0.30**	**24**
	▪ **Employment opportunities for members of custom village**	**80**			
	Sub-total				**82.1**
4	THREATS				
4.1	**Competition**		**40**	**0.20**	**8**
	▪ **Number of competitors** ▪ **Other competitors improve quality of their services**	**40** **40**			
4.2	**Regulations**		**40**	**0.20**	**8**
	▪ **Complying with the health requirements for microfinance institution**	**40**			
	▪ **Changing regulations**	**40**			
4.3	**Economic factors**		**50**	**0.30**	**10**
	▪ **Lack of research and planning to identify external opportunities & threats**	**50**			
	▪ **Unstable and stagnant macroeconomic condition**	**50**			
4.4	**Socio-cultural factor**		**55**	**0.30**	**16.5**
	▪ **Changing clients attitude**	**55**			
	▪ **Changing social attitude of rural people because of more diverse society in the future**	**55**			
	Sub-total				**40**

		Score	Average percent	Weight	Sub-Total
	FINAL SWOT SCORE				65.7

Differential Scores	Strengths - Weaknesses	81.6 – 55.5 = 26.1
	Opportunities – Threats	82.1 – 42.5 = 39.6

Main implications of the SWOT Analysis

Flavel and Williams (1996) indicate that a final score of 61-80, suggests that while the enterprise may have excellent competitive advantage, it may be concentrated in one or two areas. This is the case with LPD Mas which has an overall score of 65.7 (see Table 8.1), indicating that it should be looking to consolidate its position and/or for new product/markets. The strengths are in significant areas such as its relationship with its stakeholders, location of operation, operational cost, return on assets, operational self-sufficiency, and sales trend. This LPD is also capable of minimising its weaknesses. The LPD Mas has considerable opportunities to diversify its business unit and to keep its existing clients. There is no major threat faced by this LPD. Based on the SWOT analysis and the strategic management approach in formulating a mission statement, objectives, and strategies discussed in Chapter 5, I recommend a mission statement, along with objectives and strategies for LPD Mas of Ubud in the district of Gianyar in Bali Province as follows:

Recommended Mission Statement for LPD Mas of Ubud

As discussed in Chapter 5, a mission statement reveals the long-term vision of an enterprise in terms of *what it wants to be* and *who it wants to serve* and it should describe the enterprise's purpose, customers, products or services, market, and technological areas of emphasis in a way that reflects the values and priorities of the strategic decision makers (Flavel and Williams 1996, p. 51; Pearce II and Robinson 2003, p. 13). In short, a mission statement should consider the client groups to be served, the client needs to be met, and how the enterprise will deliver the service benefits (Flavel and Williams 1996, p. 55). Based on that consideration, I recommend the mission statement of the LPD Mas of Ubud as follows:

“To provide financial services to the community of Mas custom village through a sustainable and locally owned microfinance institution employing highly motivated staff from the community to enhance the economic development of Mas custom village.’

Recommended Objectives for LPD Mas of Ubud

As discussed in Chapter 5, objectives can be defined as specific results that an organisation seeks to achieve in pursuing its basic mission (David 2001, p.11). There are seven criteria to be used in preparing the objectives: acceptable, flexible, measurable over time, motivating, suitable, understandable, and achievable (Pearce II and Robinson 2003, 157-158). Acceptable means that managers are most likely to pursue objectives that are consistent with their preferences. Flexible means that objectives should be adaptable to unforeseen or extraordinary changes in the firm’s competitive or environmental forecasts. Measurable means that objectives must clearly and concretely state what will be achieved and when it will be achieved. Motivating means that people are most productive when objectives are set at a motivating level - one high enough to challenge, but not so high as to frustrate, or so low as to be easily attained. Suitable means that objectives must be suited to the broad aims of the firm, which are expressed in its mission statement. Lastly, understandable means that management at all levels must understand what is to be achieved. Using the Balanced Scorecard approach, an enterprise performance can be evaluated from four perspectives: financial performance, customer knowledge, internal business process, and learning and growth (Kaplan and Norton 1996). Based on the seven criteria of the objectives and the four perspectives that have to be considered in evaluating an enterprise performance, I recommend the key objectives of the LPD Mas of Ubud as follows:

The key objectives of LPD Mas are:

1. Provide and develop financial services, with emphasis on maintaining existing clients and attracting potential clients;

2. Improve the well-being of Mas custom village by providing employment and credit and savings opportunities through the growth of the business size of the LPD Mas;
3. Enable LPD Mas to preserve its sustainability by maintaining high efficiency and profitability rates;
4. Improve the internal management system operating the LPD Mas;
5. Improve the management expertise by providing training opportunities for the staff.

Recommended Strategies for LPD Mas of Ubud

As discussed in Chapter 5, strategies are the means by which long term objectives will be achieved. The enterprise strategies concern *how*: 'how to grow the business, how to compete with rivals, how to respond to changing market conditions, how to manage each functional piece of the business and develop needed organisational capabilities, how to achieve strategic and financial objectives'. Based on the SWOT analysis, vision, mission, and objectives that have been done and formulated, the strategies in enhancing the development of LPD Mas in the future are as follows:

1. Develop new financial services based on market segments;
2. Develop a marketing strategy (including promotion and delivery mechanism) to create and maintain new and existing client loyalty;
3. Undertake the necessary economic feasibility of diversifying into other business activities;
4. Compile an audit of skills available from the local community that may be utilised by the LPD Mas for developing existing and new business activities;
5. Develop measures to monitor progress against performance targets and objectives;
6. Develop a research and development program to monitor the changing economic environment;
7. Develop a promotions and staff development system to maintain staff motivation;
8. Develop and implement the necessary training program.

8.3 A SWOT ANALYSIS OF LPD KERTA OF PAYANGAN, GIANYAR, BALI

LPD Kerta was established in 1989 to support the rural economic development of the Kerta custom village. It is located in Payangan, an agriculture based sub-district, in Gianyar district of Bali province. It was established based on the Bali Governor's Decree No.55/1989. In 2001, LPD Kerta had total assets of Rp1401 million, total equity of Rp190.8 million, bank deposits in Bank BPD Bali of Rp74.4 million, and profit of Rp80.2 million and served 497 borrowers, 1030 savers, and 192 depositors (see Tables 4 and 6 in Appendix 10). It has a motto 'Mari menabung untuk meningkatkan masa depan kita bersama', which means (more or less) 'Let us save to improve our future'.

As with LPD Mas, the internal strengths and weaknesses and the external opportunities and threats of the LPD Kerta were mainly identified from consultations and discussions with the owners, managers, members of the Commissioner Board, and other stakeholders involved in the LPD, such as the local government of Bali and Bank BPD Bali. In addition, the analysis in Chapter 6 and Chapter 7, and some indicators of LPD Kerta in Appendix 10, are also used as additional basis for this analysis. Following the procedure of LPD Mas of Ubud, the SWOT table for LPD Kerta is presented in Table 8.2. A summary of key findings from the analysis follows below.

Summary of main strengths

The first strength of internal management of LPD Kerta lies in its planning and organising process that has been one of the affecting factors of its sustainability since 1989. This strength is shown by the establishment history and operational system of LPD Kerta that has been supported by some organisations - including local government at all levels, Bank BPD Bali, and custom village - through their involvement in supervision and guidance. In addition, the strength is also reflected by the simple organisation structure of LPD Kerta that results in a manageable span of control, a clear

and distinctive job description of the staff, and well-distributed responsibility between each unit. All of these factors will be significant advantages in the development and operation of the LPD Kerta in the future.

The second strength of LPD Kerta is in personnel management. This strength is indicated by its recruitment procedure, remuneration system, motivation of staff, and productivity of staff. The core management committee of LPD Kerta is selected from the local community (*krama desa*) of the Kerta custom village and elected during village meetings (*paruman desa*) for four year periods. This selection process is based on the character (track record) of the committee candidates. The remuneration system of LPD Kerta is another strong point. This system is based on the cost of living and financial capability of the LPD. LPD Kerta has applied the management compensation system based on performance which consists of a combination of a fixed salary plus some bonuses or incentive payments. One type of incentive is awarded on the 20th of every month. The Chairperson points out that this incentive is given in order to keep the staff motivated. The advantage of this system is it is fair and accountable since it is a function of observable and measurable variables, such as profits or loan instalments recovered. The satisfaction of the staff with the remuneration system is indicated by the high work motivation of the staff as indicated by a zero absence rate and low turn over.

The third strength of LPD Kerta lies in its financial management and financial conditions. LPD Kerta has applied standardised financial reporting (monthly and annually) and budget preparation systems (annually) set up by Bank BPD Bali. In terms of the financial aspect, its assets and equity, Bank deposits in Bank BPD Bali, and the profit of LPD Kerta have increased significantly (see Table 4 in Appendix 10).

In regard to its marketing management, LPD Kerta also has some strengths. It offers financial services – including loans, savings, and deposits – needed by the local community members. LPD Kerta applies a delivery mechanism which is simple and flexible to suit the local community. In its credit mechanism, for example, LPD Kerta has applied the character-based lending approach which is considered a very

advantageous and cheap technique in the literature. Concerning the pricing policy (interest rate determination), even though its lending rate has been relatively higher than the average commercial bank interest rate, LPD Kerta offers other advantageous to their clients such as simpler and easier procedure, faster disbursement, and collateral free for loans of less than Rp500 thousand.

LPD Kerta also has been attempting to enhance its clients' savings which is explicitly articulated in its motto mentioned earlier. Most of its clients' savings is collected through mobile services. LPD Kerta staff members visit the clients each day of the week, often on market day, collecting savings deposits and loan repayments. The advantage of this practice is that it can reduce transaction costs for both the clients and the microfinance institution it-self. Moreover, this practice could also be expected to increase the loan repayment rate through the increase of financial discipline.

LPD Kerta has also conducted a promotion strategy to penetrate the market and to create client loyalty.[70] The strategy includes giving gifts and scholarships to primary and secondary school students who have outstanding achievements, donations for *pura* (temple) building, and donations for *banjar* (hamlet). The Chairperson states that to date LPD Kerta has given scholarships to 12 primary school students.

Summary of main weaknesses

The first weakness of LPD Kerta management is that it possesses no formal research and development program and promotion and staff development system. In a changing socio-economic environment, a research and development program is indispensable to keep the competitive advantage of an organisation. A promotion and staff development system is also needed to stimulate the motivation of the staff.

In addition, other weaknesses of LPD Kerta are an inadequate training program and poor supporting equipment. At present the LPD has no planned program of training for

[70] The data on the growth of its clients, loans and savings is presented in Appendix 10.

its staff, both in general management and in specific areas such as risk and banking management. The supporting equipment of LPD Kerta, particularly computers, is limited as it only has one computer unit.

All of these weaknesses, however, are general characteristics of most small enterprises. The management considers that those matters are not urgent at the present time.

Summary of opportunities

LPD Kerta has a strong opportunity to evolve in the future based on its access to market, its pricing policy, quality of services, client loyalty, inferior quality of competitors, and employment source. Like other LPDs, LPD Kerta has very close access to its market since it serves the local community (custom village). With a good quality of its services, as mentioned in the strengths summary above, accompanied by its competitive pricing policy especially savings interest rate and supports from custom village, LPD Kerta will be able to create its clients' loyalty and compete with its competitors.

Summary of threats

The main threat to LPD Kerta would be a change in clients' attitude and the social attitudes of rural people. As is known, the establishment and operation arrangement of this institution was mainly based on the social custom of the Balinese. When the social custom changes, because of larger market transactions and a more diverse society, the changes could have a negative influence on the LPD, especially the compliance of its clients. Lack of research and planning to identify external opportunities and threats and an unstable and stagnant economic condition would also be potential threats to LPD Kerta. The LPD needs to identify its opportunities and threats as well as the needs of a stable and growing economic condition to evolve as a more profitable and sustainable microfinance institution in the future.

Another potential threat is a decreasing trend in number of clients, including borrowers and savers. Even though the value of outstanding loans and savings/deposits increased in the period 1996 to 2001, the actual number slightly decreased (see Table 6 in Appendix 8). This is an early warning for the management to identify the factors affecting the decrease in number of clients and undertake necessary strategies to increase the number of clients by maintaining existing clients through creating its loyalty and to attract new potential clients.

The competition condition of microfinance institutions in Kerta custom village is low since there is only one competitor of LPD Kerta the Koperasi Desa Astiti Praja (Astiti Praja Village Cooperative) and its emphasis is on a different business activity that is selling daily needs products. However, changing clients' tastes and needs may also be a factor which will need attention, perhaps by diversification of financial services. Changing government regulations could be also a threat for LPD Kerta in the future. However, so far most government regulations concerning microfinance institutions have suited LPD Kerta.

Table 8.2 SWOT Analysis Table
LPD Kerta of Payangan, Gianyar, Bali

		Score	Average percent	Weight	Sub-Total
1	STRENGTHS				
1.1	**Organisation arrangements**		**73.3**	**0.25**	**18.3**
	▪ **Planning and organising**	**80**			
	▪ **Relationship between the LPD management, Board of Commissioner, Supervisory Board, and other stakeholders**	**90**			
	▪ **Size of operation**	**70**			
	▪ **Location of operation**	**70**			
	▪ **Access to general staff**	**70**			
	▪ **Access to specialised staff**	**60**			
1.2	**Personnel aspect**		**73.75**	**0.20**	**14.75**
	▪ **Recruitment procedure**	**80**			
	▪ **Remuneration system**	**70**			
	▪ **Motivation of staff**	**80**			
	▪ **Productivity of staff**	**65**			

		Score	Average percent	Weight	Sub-Total
1.3	**Financial aspect**		**68**	**0.25**	**17**
	▪ **Financial reporting**	**75**			
	▪ **Budget preparation**	**75**			
	▪ **Operating cost ratio**	**60**			
	▪ **Return on Assets**	**60**			
	▪ **Operational self-sufficiency**	**70**			
1.4	**Marketing aspect**		**65**	**0.20**	**13**
	▪ **Marketing strategies**	**65**			
	▪ **Financial services designs**	**65**			
	▪ **Delivery mechanism**	**70**			
	▪ **Pricing policy**	**70**			
	▪ **Promotion activities**	**70**			
	▪ **Sales trends**	**50**			
1.5	**Infrastructure/equipment**		**56.2**	**0.10**	**5.6**
	▪ **Vehicles**	**60**			
	▪ **Computer/printer**	**50**			
	▪ **Typing machine**	**60**			
	▪ **Office equipments**	**55**			
	Sub-total				**68.65**
2	WEAKNESSES				
2.1	**Organisational arrangements**		**55**	**0.30**	**16.5**
	▪ **Lack of a mission statement**				
	▪ **Lack of research and development program**	**50**			
	▪ **Lack of promotion & staff development system**	**60**			
2.2	**Skills of staff**		**55**	**0.30**	**16.5**
	▪ **Staff capacity & capability**	**55**			
	▪ **Inadequate training in general management**	**50**			
	▪ **Inadequate training in specific area such as financial management and banking management**	**60**			
2.3	**Financial aspect**		**40**	**0.30**	**12**
	▪ **Increasing trend in operating cost ratio**	**40**			
	▪ **Decreasing trend in return on assets**	**40**			
	▪ **Decreasing trend in operational self-sufficiency**	**40**			
2.4	**Equipment**		**55**	**0.10**	**5.5**

		Score	Average percent	Weight	Sub-Total
	▪ **Quality of computers equipment**	**55**			
	▪ **Quantity of computers equipment**	**55**			
	Sub-total				**50.5**
3	OPPORTUNITIES				
3.1	**Access to markets**		**72.5**	**0.30**	**21.75**
	▪ **Serve local community**	**75**			
	▪ **Competitive pricing policy**	**70**			
3.2	**Marketing**		**68.3**	**0.40**	**27.3**
	▪ **Quality of services**	**70**			
	▪ **Inferior quality of competitors services**	**70**			
	▪ **Clients loyalty**	**65**			
3.3	**Employment**		**80**	**0.30**	**24**
	▪ **Employment for members of custom village**	**80**			
	Sub-total				**73.03**
4	THREATS				
4.1	**Competition**		**45**	**0.15**	**6.75**
	▪ **Number of competitors** ▪ **Other competitors improve quality of their services**	**50** **40**			
4.2	**Regulations**		**40**	**0.15**	**6**
	▪ **Complying with the health requirements for microfinance institution**	**40**			
	▪ **Changing regulations**	**40**			
4.3	**Macroeconomic environment**		**55**	**0.20**	**11**
	▪ **Lack of research and planning to identify external opportunities & threats**	**55**			
	▪ **Unstable and stagnant macroeconomic condition**	**55**			
4.4	**Outreach**		**40**	**0.25**	**10**
	▪ **Decreasing trend in number of borrowers**	**40**			
	▪ **Decreasing trend in number of savers & depositors**	**40**			
4.5	**Socio-cultural factor**		**55**	**0.25**	**13.75**

		Score	Average percent	Weight	Sub-Total
	▪ **Changing clients attitude**	**55**			
	▪ **Changing social attitude of rural people because of more diverse society in the future**	**55**			
	Sub-total				**47.5**
	FINAL SWOT SCORE				43.7

Differential Scores	Strengths - Weaknesses	68.65 – 50.5 = 18.15
	Opportunities – Threats	73.05 – 47.5 = 25.55

Main implications of the SWOT Analysis

The LPD Kerta has an overall score of 43.7 (Table 8.2). Flavel and Williams (1996) indicate that a final score of 41-60 suggests that LPD Kerta has considerable competitive advantage. However, further analysis is recommended before the LPD decides to expand its business. The strengths of LPD Kerta are in areas such as planning and organising, its relationship with its stakeholders, recruitment procedure, motivation of staff, financial reporting, and budget preparation. The LPD has no significant weaknesses. This LPD has substantial opportunities to create employment for local people and to serve the local community better. There is no significant threat faced by LPD Kerta. As was the case with LPD Mas discussed earlier, based on the SWOT analysis above and the approach in formulating a mission statement, objectives, and strategies discussed earlier, I recommend a mission statement, along with objectives and strategies for LPD Kerta of Payangan in the district of Gianyar in Bali Province as follows:

Recommended Mission Statement for LPD Kerta of Payangan

'To provide financial services that suit the needs of the community of Kerta custom village by employing staff from the local community to become a sustainable microfinance institution in the future.'

Recommended Objectives for LPD Kerta of Payangan

The key objectives of LPD Kerta are:

1. Provide and develop better financial services that suit the local community needs;
2. Improve the well-being of Kerta custom village by providing credit and savings opportunities through the growth of the business size of the LPD Kerta;
3. Enable LPD Kerta to become a sustainable microfinance institution by achieving high efficiency and profitability;
4. Improve the internal management system in operating the LPD Kerta;
5. Improve the internal management expertise by providing training opportunities for the staff

Recommended Strategies for LPD Kerta of Payangan

1. Develop new financial services based on market segments;
2. Develop a marketing strategy, particularly promotion strategy, with the purpose of maintaining existing client loyalty and to attract new clients;
3. Compile an audit of skills available in the local community that may be utilised for the development of LPD Kerta;
4. Develop measures to monitor progress against performance targets and objectives;
5. Develop a research and development program to monitor the changing environment;
6. Develop a promotion and staff development system to maintain staff motivation;
7. Develop and implement the necessary training program.

CHAPTER NINE

TOWARDS A SUSTAINABLE MICROFINANCE INSTITUTION

9.1 INTRODUCTION

This study assesses the performance and sustainability of a local microfinance institution – that is, the Village Credit Institution (*Lembaga Perkreditan Desa* or LPD) of Bali – as a case study. It endeavours to cast light on the ways in which the LPD has been operated and managed to achieve its sustainability within its economic and socio-cultural environments. Consequently, the study focuses on financial performance, outreach, institutional environment (including formal and informal institution), and the relationships between formal and informal institutions. The main aspects of institutional environment analysis are the linkages between microfinance institutions and local institutions, and/or relationship between informal institutions and formal institutions that affect the sustainability of the LPDs. This focus distinguishes this study from previous studies. As argued by Snow (1999, p.66), these issues receive only little attention from scholars, despite the fact that the institutional environment is a key factor affecting the sustainability. A better understanding of the institutional environment is particularly important since fostering microfinance institutions has become an integral part of the development strategy for rural development in Indonesia and many developing countries.

This study takes a different methodological approach from previous studies on the performance of microfinance institutions in Indonesia (Chaves and Gonzales-Vega 1996; Mosley 1996a; Charitonenko, Patten et al. 1998; Yaron, Benjamin et al. 1998). As noted in Chapters 1 and 5, this study employs a single case study strategy using an

embedded case study design that distinguishes this study from previous studies that have used a multiple case study approach using a holistic case study design. The embedded case study design is considered more appropriate in assessing a complex phenomenon such as microfinance institutions and in assessing the influence of the socio-cultural environment on performance and sustainability since as argued by Yin (2003) this case study design allows the researcher to have more extensive analysis and insights into the case.

Moreover, this is the first study that explores the LPD as a single case. This case is very interesting since it is considered, as noted in Chapter 5, a *par excellence* example of a fully sustainable microfinance institution in Indonesia. Better knowledge about the LPD is expected to help scholars, microfinance practitioners, and policy makers formulate and design an appropriate microfinance institution scheme in Indonesia.

This concluding chapter will pull together the main elements of each chapter and relate them to the underlying theme of the thesis, which is an assessment of the performance and sustainability of the LPD and the affecting factors. It makes a number of suggestions of what this case study tells us about the nature of the LPD and draws lessons from this case study for broader interpretative approaches to microfinance institutions. Ultimately, it is expected that the thesis will offer some illuminating empirical material on understanding better the features of microfinance institutions in Bali, and on interpreting the existence of microfinance institutions in Indonesia in general.

9.2 SUMMARY OF FINDINGS

Based on the discussions in previous chapters, especially the institutional analysis in Chapter 6, which discussed the influence of informal institutions, formal institutions, and the macroeconomic condition on the performance and sustainability of the LPD, and the financial performance and outreach analysis in Chapter 7, it could be concluded

that the LPDs of Gianyar district have been able to be healthy and sustainable microfinance institutions. The factors affecting sustainability are categorised into external and internal factors. The external factors include government regulations (formal institutions), socio-cultural rules and practices that shape personal conduct of the clients of the LPD (informal institutions), and macroeconomic conditions. The internal factors include the internal management and the practical operational arrangement of the LPDs that directly affect their financial performance and outreach, which in turn affect their sustainability. A summary of the affecting factors and the interrelationships between the factors is illustrated in Figure 9.1.

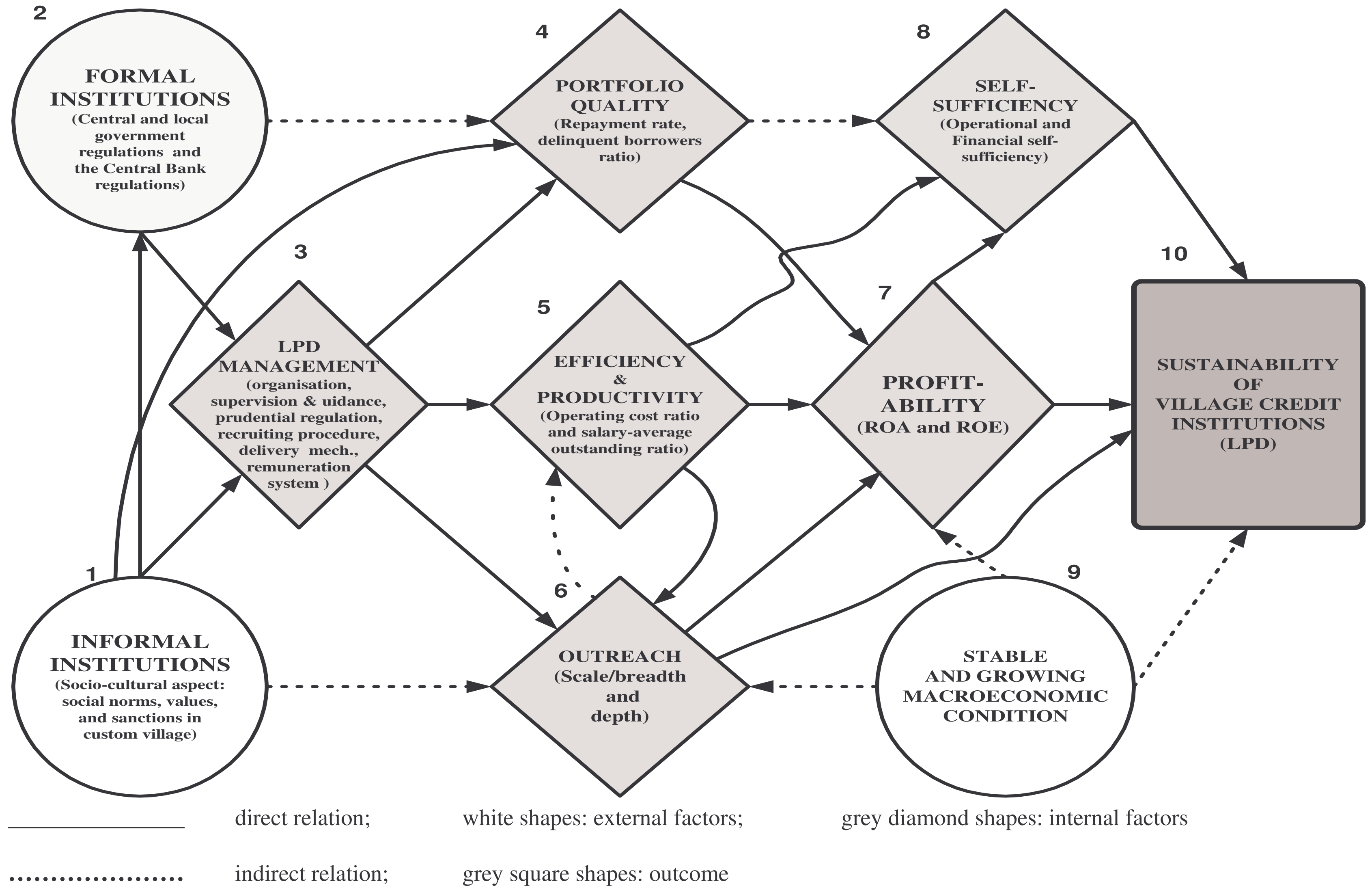
The influence of informal institutions

This thesis argues that the LPD is unique because it is directly influenced by Balinese social custom comprising social values, norms, and sanctions (informal institutions) as shown in Figure 9.1. The evidence of this influence is indicated in its practical operational arrangement, including the organisation, recruitment procedure, delivery mechanism, and remuneration system.

In its daily operational activities the LPD management has to be accountable to the custom village through its leader (*Bendesa Adat*) who is ex-officio as the Chief of Commissioner Board of LPD. For instance, the LPD's activities and budget plan has to be approved by the *Bendesa Adat.* In addition, the LPD management also makes an annual financial report which is submitted to *Bendesa Adat*. This reveals the strong relationship between the LPD and its community (custom village).

The recruitment procedure also reflects the influence of informal institutions. The core management team and the staff are recruited and selected from the community members (*krama desa*) of the custom village and elected during village meetings (*paruman desa*). This recruitment has to be approved by the *Bendesa Adat* based on the aptitude and an attitude test (character-based or reputation) of the candidates.

Figure 9.1 Factors Affecting Performance and Sustainability of Village Credit Institutions (LPDs) of Bali



The LPDs' delivery mechanism is also influenced by informal institutions. The principle of the loan delivery of the LPD is on an individual basis and can only be given to the members of the custom village (*desa adat*) where the LPD located. The loan applicant screening process involves the *Bendesa Adat*. After filling out the loan application, the applicant has to go to the *Bendesa Adat* to ask for a reference. The reference is mainly based on the character (reputation) of the applicant. This mechanism clearly shows that the LPD uses existing social structures in screening potential borrowers to ensure that the potential borrowers are selected appropriately and repayments are made on time. The use of the *Bendesa Adat* in the custom village to help screen loan applicants has secured prompt loan collection. In this instance, the LPD relies on the reputation, authority, official and social status of the *Bendesa Adat* to overcome one of the principal deficiencies of general banking: inadequate information on the creditworthiness of potential borrowers.

According to the custom village regulations (*awig-awig*), social sanctions could be applied to the clients and the staff of LPDs who violate the rules, for instance, by not repaying their credits properly or mismanagement (such as collusion or corruption). The heaviest social sanction is the exclusion of the delinquent borrower from the community, which means that they lose their share of community ownership and the plot of land on which their family compound is built is withdrawn. They could also lose the right for a funeral in the village cemetery and subsequent cremation. He/she could become an outsider without the security of the community and must look for a new life far away from their native village. So far, the custom village regulation has been effective in overcoming the problem of delinquent borrowers or low repayment rates or misbehaviour of staff. In short, the threat of these sanctions has contributed to keeping the rate of delinquent borrowers ratio very low.

The remuneration system of the LPD is generally intended to stimulate better performance of its staff, especially in collecting loans and promoting and servicing savings. Even though the remuneration system of each LPD differs from one to another, there is a similarity in the determination of the basic salary for the Chairperson

of the LPD. The basic salary of a Chairperson is based on the cost of living, for instance, the wage of an artisan (sculptor) or a worker per day in the village where the LPD located. The bonus and other incentives received by the staff are based on the financial capability (such as profit) of each LPD. The determination of basic salary clearly shows the embeddedness of the LPD with its local socio-economic environment. This is one of the important factors affecting the sustainability of LPDs. As revealed by many studies (Meyer and Rowan 1977; DiMaggio and Powell 1983; Baum and Oliver 1991; Rhyne and Otero 1992; Carrol 1993; Chaves and Gonzales-Vega 1996; Oliver 1997; Snow 1999) the embeddedness of a firm - such as a microfinance institution - with its socio-economic environment significantly influences sustainability.

The influence of formal institutions

Along with the influence of informal institutions, Figure 9.1 shows that the formal institutions also have some direct influences on the practical operational arrangement of LPDs. The influences are reflected in the supervision and guidance system of LPDs, an obligation to apply prudential principle of banking, and remuneration system.

The Provincial Regulation No.8/2002 and the Governor's Decree No.3/2003 appoint three groups of institutions involved in giving supervision and guidance for the LPDs both at provincial and district level. They are the local government (Governor and Mayor Office), Bank BPD Bali (Head and Branch Office), and the LPD organisations (*Pembina Lembaga Perkreditan Desa Propinsi* or PLPDP is provincial supervision organisation; *Pembina Lembaga Perkreditan Desa Kabupaten/Kota* or PLPDK is district supervision organisation). The function of the provincial government is limited to general guidance, recognition, and supervision. The provincial government is not at all involved in the day-to-day running of the LPDs. Bank BPD Bali has three functions in respect to the LPDs: to conduct technical guidance, to manage coordination with the other organisations related to the guidance and supervision of the LPDs, and to provide a quarterly evaluation report on the financial performance and the healthiness of the LPDs to the Governor. Further, in practice Bank BPD Bali also acts as the 'banker' for

LPDs. The function of PLPDP is limited only to coordinating the PLPDK activities and the function of PLPDK has to monitor the condition of the LPDs and conduct technical guidance, institutional development and training for the staff of the LPDs in their operational area.

Based on the analysis, it can be concluded that the intervention of these organisations has been at the appropriate level in fostering and supporting the development of LPDs in Bali. Referring to the theory of institutional development (Uphoff 1986), the Bali local government has applied an assistance mode through provision of a legal basis for the LPDs and general supervision and guidance. According to the theory, when the local institutions are strong and possess community linkages – as is the case with the LPDs - outside intervention may take the mode of assistance.

In regard to the practical operational arrangement of the LPDs, the Provincial Regulation and the Central Bank (Bank Indonesia) regulation imposes prudential banking regulations on the LPDs to achieve healthy financial institutions. This regulation sets the criteria of the capital adequacy ratio (CAR), productive asset quality, management aspect, earnings, and liquidity - the so-called CAMEL criteria. This regulation has also contributed to the good performance of the LPDs.

The relationship between informal and formal institutions

As shown in Figure 9.1, the local government regulations (formal institutions) concerning the LPDs have accommodated the informal institutions (including social custom, values, and norms) of Balinese society. The evidence is reflected in the background of establishment, status and ownership, and organisation of the LPDs. Both the former LPD Regulation 1988 and the new Regulation 2002 clearly state that the regulations were enacted in order to maintain and improve the existence and independence of *desa adat* (custom village). The explanation of the Regulations state that the LPDs are community financial institutions owned, managed and used by the members of the *desa adat.*

The elucidations of the Regulations also state that the LPD is unique since its operational arrangement is based on Balinese custom. The establishment of LPDs is based on local needs and directed towards the development of a decentralized and community-owned financial system. One of the requirements for LPD establishment[71] implies that the Regulations accommodate the informal institutions (including rules, behavioural norms and code of conduct for the community of a custom village) of Bali. The elucidations undoubtedly recognise that customary law will be more obeyed by the members (*krama desa*) of *desa adat* (custom village) since the social custom, values, and norms have existed for centuries. The connections between the microfinance institution and the local community are further cemented by the requirement that the daily operational activities of the LPD have to be accountable to the custom village through its leader (*Bendesa Adat*), and the core management team has to be recruited and selected from the community members (*krama desa*) of the village and elected during village meetings (*paruman desa*).

9.3 IMPLICATIONS OF THE STUDY

In the previous sections, the main findings of the study have been summarised and related back to the underlying theme of the thesis, namely assessing the affecting factors of the performance and sustainability of microfinance institution. The focus is now on the issue of what the study tells us about the nature of microfinance in Indonesia, and will then proceed to an outline of its implications for previous scholars' interpretations of this matter.

It is realised, however, that it would be too simplistic to make a claim that this study reflects the features of Indonesia's microfinance institution development as a whole. To be able to do this would certainly require a wider study covering more aspects of microfinance institutions and involve more microfinance institutions. This study covers only a single issue of microfinance institution development - its sustainability and the

[71] That is a custom village has to have written custom village regulations (*awig-awig*)

affecting factors - and was conducted in only one out of thirty Indonesian provinces – Bali. What this study hoped to achieve was to cast light on the ways in which microfinance institutions have been developed through supports from local government and the local community. It is these relationships, which have been identified in other studies as requiring further research to gain a clearer picture.

As discussed in Chapter 2, there is a strong consensus among scholars in the literature that the sustainability of microfinance institutions and a firm in general is highly influenced by its institution's environment, both informal and formal. The findings of this study with regard to the important role of the institution's environment on the sustainability of microfinance institutions fitted well with the findings of previous scholars. However, using an embedded case study approach, this study not only reveals that both informal and formal institutions evidently influenced the sustainability of the LPDs, but also finds that in Bali there is a close relationship between those two kinds of institutions. It is evident that informal institutions have significant influences on the formal institutions in Bali. Specifically, the local government regulations related to the LPDs are rooted to the culture, social values, and norms of the Balinese. This is the key success factor of the effectiveness and appropriateness of local government regulations related to the LPDs in Bali. As argued by the World Bank (2002), an inadequate attention on the norms and culture (informal institution) of a society is likely to result in formal institutions not delivering the desired outcomes.

Therefore, there are three lessons that could be learned by scholars, microfinance practitioners, and policy makers from this study. First, it is evident that informal institutions have succeeded in coping with the problem of risk in rural credit and, in turn, have contributed significantly to the sustainability of the LPDs in Bali. Since all societies and cultures have cultural institutions and practices, there are possibilities to embed some practical arrangements of the LPD in other parts of Indonesia. Second, the formal regulations of microfinance institutions have to be based on the socio-cultural aspect of society in order to achieve sustainability. Ignoring or giving inadequate attention to the culture, social values, and norms of the society will cause ineffective

formal regulations. Third, an assessment to what level the intervention of government at all levels should be in the development of microfinance institutions is also a key factor in the sustainability of microfinance institutions. The theory of institutional development suggests three levels of intervention; assistance, promotion, and facilitation. This level of intervention is dependent on local capacity to deliver a product or service. In the case of LPDs, the intervention undertaken by local government in Bali is at the assistance level. As discussed in Chapter 6, when the local institutions are strong and possess community linkages, outside intervention may take the mode of assistance.

In this study, there are two other areas recognised as important, but which could not be fully explored. I would like to put these areas forward as possible subjects for future research on the practical operational arrangement of LPDs in particular and microfinance institutions in general. The first area of research, as noted earlier, is the intervention level of government on the development of microfinance institutions. As discussed in Chapter 3, microfinance institutions in Indonesia vary greatly terms of size, type, and location. Further study focusing on the assessment of the ideal level of local government intervention on several types of microfinance in other provinces in Indonesia could be very useful for policy makers and practitioners of microfinance in Indonesia. This is particularly relevant in the context of Indonesian devolution.

The second is how to create an appropriate arrangement among LPDs when an LPD client in one custom village asks for loan from other LPDs in a different custom village. The current regulation prohibits this but in practice some LPDs have flaunted this rule because they possess excess liquidity while other LPDs are unable to satisfy demand due to insufficient liquidity. This practice could be a serious problem faced by LPDs, especially in enforcing contractual agreements – for instance, in enforcing the repayment of the clients - between the LPD and its clients because the clients are only tied by the *awig-awig* of their own community. This problem is inevitable when their business size and credit transactions grow and the socio-cultural aspects of clients become more diverse.

Finally, the methodology used in this study distinguishes it from previous studies on microfinance institutions in Indonesia such as Yaron *et al* (1998), Ravicz (1998), Chaves and Gonzales-Vega (1996), Riedinger (1994), and Yaron (1994). These previous studies only focus on the financial performance of some microfinance institutions in Indonesia using consolidated financial data at provincial level and do not focus on the interactions between informal and formal institutions as this study does. This study focuses on institutional environment analysis and includes the linkages between microfinance institutions and local institutions, and/or relationships between informal institutions and formal institutions that affect the sustainability of the LPDs. These focuses have distinguished this study from previous studies.

In addition to these methodological layers, a longitudinal study in assessing the performance and sustainability of the LPDs by using a longer time series data and by examining the changes of the LPDs performance over a longer time period would yield stronger findings. However, because of the limitations of time and other resources, this study only focuses on the condition of the LPDs in the period 1999 to 2001.

As discussed in Chapter 5, the study uses an embedded case study design in assessing the factors affecting the performance and sustainability of the LPDs. Therefore, the LPDs are analysed on two levels. On the first level, the study assesses the performance and sustainability of LPDs at the district level focusing on Gianyar district. On the second level, the performance and sustainability of the LPD at firm (unit) level is assessed using SWOT analysis in order to create some elements of business plans for the LPDs. Two LPDs were chosen as representative of two different regions; the LPD of Mas village (handicraft industry based region) and the LPD of Kerta village (agricultural based region). As noted earlier, the advantages of this case study design are that it makes a case study inquiry more focused, while a holistic case study design – that used by most previous studies - examines only the global nature of a microfinance institution - and uses consolidated financial data of the microfinance institutions at provincial level.

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APPENDICES

APPENDIX 1:
CALCULATION METHOD OF PERFORMANCE INDICATORS

1. Portfolio Quality

$$RR = \frac{LPPDS}{PO}$$

RR : Repayment rate
LPPDS : Loan portfolio (pass + doubtful + sub-standard)
PO : Portfolio outstanding (including amounts past due)

$$DBR = \frac{DBR}{TNAB}$$

DBR : Delinquent borrowers ratio
NDB : Number of delinquent borrowers
TNAB : Total number of active borrowers

2. Productivity and efficiency ratios

The productivity ratios used in this study include number of active borrowers per staff, portfolio outstanding per staff, total amount disbursed in the period per staff, number of active depositors per staff, deposits outstanding per staff, and total amount of savings collected in the period per staff.

Efficiency indicators used in this study are operating cost ratio and salaries as percentage of average portfolio outstanding.

$$OCR = \frac{OC}{APO}$$

OCR : Operating cost ratio
OC : Operating costs
APO : Average portfolio outstanding

$$SAPAPO = \frac{SAB}{APO}$$

SAPAPO : Salaries as a percentage of average portfolio outstanding
SAB : Salaries and benefits
APO : Average portfolio outstanding

3. Financial viability

To determine financial viability, two self-sufficiency indicators are calculated, which are operational self-sufficiency and financial self-sufficiency.

- $$OSS = \frac{OI}{OE + PLL}$$

  OSS : Operational self-sufficiency
  OI : Operating income
  OE : Operating expenses
  PLL : Provision for loan losses

- $$FSS = \frac{OI}{OE + FC + PLL + COC}$$

  FSS : Financial self-sufficiency
  OI : Operating income
  OE : Operating expenses
  FC : Financing costs
  PLL : Provision for loan losses
  COC : Cost of capital

4. Profitability ratios

Two profitability ratio used in this study include return on asset (ROA) and return on equity (ROE).

- $$ROA = \frac{NI}{AA}$$

  ROA : Return on assets
  NI : Net income
  AA : Average assets

- **ROE (adjusted)** $$= \frac{NAI}{AE}$$

  ROE adjusted : Adjusted Return of equity
  NAI : Net adjusted income
  AE : Average equity

5. Leverage and Capital Adequacy

A microfinance institution's leverage is measured by calculating its debt to equity ratio. The debt to equity ratio states how much debt a microfinance institution has relative to its equity. In this study, debt of LPD consists of savings and time deposits of its clients, since LPD does not borrow any fund from other institutions.

$$DER = \frac{D}{E}$$

DER : Debt to equity ratio
D : Debt
E : Equity

Capital adequacy refers to the amount of capital an MFI has relative to its assets. Capital adequacy relates to leverage in terms of the adequacy of the microfinance institution's funding structure. Capital adequacy means that there is a sufficient level of capital required to absorb potential losses while providing financial sustainability.

Capital adequacy is usually measured by the following ratio of *capital to risk-weighted assets*:

$$CRWA = \frac{IC + R + RE}{RWA}$$

CRWA : Capital to risk-weighted assets
IC : Invested capital
R : Reserves
RE : Retained earnings
RWA : Risk-weighted assets

The calculation of Capital Adequacy Ratio (CAR) is based on the ratio of capital to risk-weighted assets. For microfinance institutions in Indonesia, as well as the LPDs, as set out by Bank Indonesia (the Central Bank) the capital consists of invested capital (initial capital), provision for loan losses, retained earnings and current profits. Meanwhile, the risk-weighted assets are classified into five categories whose the standard risk weights ranging from 0 percent to 100 percent risk. The first category is cash with 0 percent risk-weighted, the second is deposits in Bank BPD of Bali with 20 percent risk-weighted, the third is outstanding loans with 100 percent risk-weighted, the fourth is fixed assets with 100 percent risk-weighted, and the last is other assets with 100 percent risk-weighted.

6. Scale/breadth and depth of outreach indicators

Scale/breadth of outreach means the number of clients served with different types of instruments; the **depth** of outreach means the type of clients reached and their level of poverty.

Clients and Staff outreach:

- Number of borrowers
- Average borrowers per LPD
- Number of savers
- Average savers per LPD

- Number of deposit accounts (depositors)
- Average depositor per LPD
- Number of staff
- Average number of staff per LPD
- Percentage of total target clientele serviced (%)

Loan outreach:
- Volume of outstanding loans (billion Rp)
- Average outstanding loan per LPD (million Rp)
- Average loans per borrower (million Rp)
- Average loans per borrower as percentage of GRDP per capita[1)]

Saving/Deposits outreach:
- Volume of savings (billion Rp)
- Average savings per LPD (million Rp)
- Average savings per saver as proportion of GRDP/capita[1)]
- Volume of time deposits (billion Rp)
- Average deposits per LPD ((million Rp)
- Average deposit per depositor as proportion of GRDP/capita[1)]

APPENDIX 2:
CALCULATION METHOD OF CAMEL

Based on Circular Letter of Bank Indonesia No. 30/3/UPPB, 30 April 1997 the BPR CAMEL rating is composed and weighted as follows:

C for *capital* is weighted with 30 percent and is measured by the capital adequacy ratio, which is mandated to reach at least 8 percent to qualify for the rating "sound". Capital is composed of core capital (paid-up capital, reserves, profit retained, goodwill) and additional capital (reserves for revalued fixed assets, loan loss provisions, quasi equity, subordinated loans) and compared to risk weighted assets.

A for *productive asset quality* is weighted with 30 percent and is measured by two ratios: a) classified assets to productive assets (25 percent) and b) effective reserves against mandated reserves (5 percent). The first ratio measures portfolio at risk using 4 categories of all productive assets (pass, doubtful, sub-standard, loss), which include different instalment periods (daily, weekly, monthly, seasonal). A loan with monthly instalments is considered "pass" until repayment is 90 days overdue and becomes doubtful only on day 91 to day 180. The second ratio measures an effective versus mandated provisioning for loans. Thus, it does not measure loan quality but rather compliance to the provisioning rules.

Table Mandated Loan Provisioning

	Pass	Sub-standard	Doubtful	Loss
Mandated Loan Provisioning	0.5%	10% of loans in this category after deduction* for the value of collateral	50% of loans in this category after deduction* for the value of collateral	100% of loans in this category after deduction* for the value of collateral

* 100% may be deducted for liquid collateral and 75% of other collateral or as valued by a valuator

M for *management* is weighted with percent and is measured during on-site supervision by using a questionnaire that evaluates 25 aspects with reference to general management (10 questions) and risk management (15 questions).

E for *earnings* is weighted with 10 percent and is measured by two ratios: a) profit before tax during the last 12 months compared to average business volume within the same period (5 percent) and b) operational cost during the last 12 months compared to operational income in the same period (5 percent).

L for *liquidity* is weighted with 10 percent and is measured by two ratios: a) loan deposit ratio (5 percent) and b) quick ratio comparing liquid assets to current liabilities. LDR of 95 percent is regarded as sound.

Each of the above components is quantified using a reward system running from 0 to 100 and then weighted according to the assigned weight above. Banks achieving 81 – 100 points are regarded as sound, 66 – 80 as fairly sound, 51 – 65 as less sound and below 51 as unsound. A bank being exposed to internal conflicts, outside interference in management, window dressing or being involved in other unlawful bank activities is automatically regarded as unsound.

APPENDIX 3:
LIST OF INTERVIEWEES

No.	Name	Position	Date of Interview
1	Ida Bagus Oka Windusara	Provincial Government Officer	6 February 2002
2	I Gusti Ketut Narya	Provincial Government Officer	6 February 2002 20 February 2003
3	Ida Bagus Mayun Warsana	Bank BPD Bali Officer	7 February 2002 21 February 2003
4	Wayan Dade Wiweka	Bank BPD Bali Officer	7 February 2002 21 February 2003
5	I Nyoman Cendikiawan	Chairperson of LPD Talepud	7 and 8 February 2002
6	I Made Ardana	Chairperson of LPD Mas	21-23 February 2003
7	I Ketut Kurniawan	Chairperson of LPD Kerta	25 and 26 February 2003
8	I Wayan Sujana	Member of Commissioner Board of LPD Mas	23 February 2003
9	A. A. Gde Raka Wardana	Chief of Commissioner Board of LPD Kerta	25 and 26 February 2003
10	Ktut Rempun	LPD client	22 February 2002
11	I Wayan Kelin	LPD client	23 February 2002
12	I Wayan Warsha	LPD client	22 February 2002

APPENDIX 4:
PROCEDURE OF CONDUCTING LILLIFORS TEST

The procedure of this test is taken from Keller and Warrack (2000, p.614-617) and Coakes and Steed (2001, p.35). The procedure as follows:

Suppose a cumulative distribution function is defined as

$$F(x) = P(X \leq x)$$

The tables of cumulative binomial and Poisson distributions provide values for

$$P(X \leq k) = \sum_{X=0}^{k} p(x)$$

for several values of *k*.

The sample cumulative distribution function, *S(x)*, is defined as the proportion of sample values that are less than or equal to *x*. The mean (*x*) and *s* are calculated from the data. Then we define the test statistic *D* as the largest absolute difference between S(x) and *F(x)*. That is,

$$D = \max \left| F(x) - S(x) \right|$$

Then we test the hypotheses

H_0: The data are normally distributed
H_1: The data are not normally distributed

Suppose $\alpha = 0.05$ (level of significance for testing these hypotheses) or based on the level of significance α and the sample size we can find the critical value of *D* from the Lilliefors table. When the significance level is greater than 0.05 or D-calculated is greater than D-critical value, then normality is assumed.

APPENDIX 5:
PROCEDURE OF SWOT ANALYSIS

The data collected comprising facts and impressions and opinions from field study will be condensed into a meaningful picture that includes the main important strengths, weaknesses, opportunities, and threats. Some elements of importance are categorised and scored. Within ***the strengths*** there are the following elements:

- *Past performance*. This shows what has been done. This is the most important element and as such will be given a high weighting. Past performance is defined as 'actual business activities which have already led, or will almost certainly lead, to profits being made and/or to strengthening of the LPD's competitive position. For the LPD, the business activities are outstanding loans, profitability (return on assets and return on equity).
- *Resources/assets*. Access to additional capital, human skills, and equipment such as to underpin the current performance and potential performance of the LPD.
- *Skills*. These contribute to both current performance and potential performance of the LPD.
- *Strategies*. These relate to the appropriateness of choice of major directions taken or about to be taken by the LPD.

Within ***the weaknesses*** component there are the following elements: past performance, resources/assets, skills, and strategies. These are not mirror images of the strengths component. They relate to specific weaknesses. They are scored on a low-high scale where 'high' indicates significant weaknesses.

Opportunities and threats are the factors external to the LPD. They qualify what is happening (or could happen) in the macro economy. The categories considered are: product/market threats, political/legal action, competitor action, and business environment.

In conducting the SWOT analysis, this study employs the methodology set down by Flavel and Williams (1996). The procedures of the methodology are:

1. Identifying and considering the internal strengths and weakness of the LPD and to apply a numeric score representing the magnitude of the strength or weakness (the higher the score the greater the strength or weakness). Factors considered include:
    - Management functions including planning, organising, staffing and control.
    - Business functions including the products/services to be sold, how they will be produced and marketed to suit the needs of clients, the motivation of people involved in the LPD and financial aspects (for instance, outstanding loans and profitability).

2. Identifying and evaluating the external environment analysis (opportunities and threats) which may affect the LPD. The score is assigned to measure the magnitude of the factor involved. Some of the factors considered are:
    - The level of competition for the products/services
    - Climatic and other environmental considerations

- Legal environment consideration
- Social and demographic factors

3. Applying the weight to each group of attributes is conducted to take into account that some attributes are more important (have a greater weight) than others.
4. Calculating a final score - that relates the strengths, weaknesses, opportunities, and threats – may provide indication of the viability of the LPD. The overall strength or weaknesses of the LPD may be measured by the following:

For Plus Scores

0-40	Some advantages, but further work required before committing resources
41-60	Considerable advantage. Appears to be well placed although further analysis is recommended
61-80	Excellent advantages with need to concentrate in only a few areas
81-120	Appears to be ready for immediate implementation

For Minus Scores

0-40	Some disadvantages, but further analysis required before proceeding
41-60	Considerable disadvantage. Considerable analysis required before proceeding.
61-80	Poor case but may be confined to a few areas. Attempt to correct these before proceeding.
81-120	Severe disadvantage in a large number of areas. Unlikely to be successful.

DIANOSTIC CHECKLIST FOR SWOT ANALYSIS

INTERNAL ANALYSIS
Diagnostic checklist for the LPD

1. ORGANISATION

1.1. Planning and organising

Is there a clear mission statement?

Is there a strategic plan which is understood?

Is the organization structure suited to strategies?

Is the external environment monitored regularly?

Is an internal analysis regularly undertaken?

Are competitors monitored?

Are there clearly stated company objectives?

Are there clear goals and plans for the current year?

Are goals communicated throughout the organisation?

Are reports timely and decision-useful?

Is there an unhealthy dominance by one functional area (e.g. finance or credit)?

Check management team competence and business function performance.

Comment on strengths and weaknesses in management

1.2. Organisation structure

Does the organisational structure indicate :

- Dual subordination?
- Wide spans of control?
- Overlapping responsibilities?
- Ineffectiveness?

Are staff involved in decisions?

Does the structure enable the implementation?
Of strategies and objectives?

Are position and person specifications prepared for each job?

Are they regularly reviewed with staff?

Have projected staffing needs been identified?

- diversification?
- growth?
- retirements?

Other comments regarding :

- structure
- improvements

1.3. Motivation and morale

Is there adequate delegation and team decision making?

Is there complacency or low morale?

What is the level of staff turnover?

What is the level of absenteeism?

Check amount of overtime worked.

Check workload on key staff.

Is there tolerance of poor performance?

Check and comment on quality of leadership. Are there unresolved conflicts?

1.4. Personnel management

Review and comment on :

- recruitment procedures
- induction programs
- training programs

Review and comment on upon remuneration :

- market relativity?
- award levels?

Review and comment on employee :

- performance evaluation systems
- involvement and empowerment
- disciplinary procedures
- health and safety programs
- employee opportunity plans
- promotion and staff development plans

List the key considerations (strengths and weaknesses) and matters for follow-up.

2. FINANCIAL ASPECTS

2.1. Use ratios as a diagnostic tool and comment on :

- trends
- relative performance with the all LPD

2.2. Financing of assets

What would be the effect of :

- A decline in cash flows?
- Loss of a major customer?

Is the entity able to finance planned growth due to :

- Real growth rates?
- Inflation?

2.3. The management information system

Is performance measured against budget?

What period control reports are generated?

Does management understand the information?

Do reports show unexplained fluctuations?

Are variances :

- followed up?
- explained?
- acted upon?

Are there delays in :

- producing financial reports?
- recognition of losses?

Do financial reports enable assessment of gross profit by product and market?

Are there deteriorating trends in working capital?

2.4. Management of capital expenditure

Is a capital equipment register maintained?

Is there a capital expenditure approval policy?

What are the approval criteria (DCF, payback, IRR)?

Is there post-approval follow-up?

Is there excessive reliance on lease finance?

2.5. Auditing

Is the entity audited?

What matters were raised in the audit report?

Has management taken action on these matters?

2.6. Working capital management

Check trends in working capital ratios.

Check accounts receivable controls :

- cumulative credit records kept for each client?
- flagging when client exceed credit limit?
- aged debtor analysis prepared and followed up?

2.7. Cash-flow management

Are cash-flow forecasts prepared?

Are they reliable?

2.8. Unreliable forecasting

Compare budget/actual :

- Cash flows
- Sales
- Gross profit
- Expenses
- Other

Is there evidence of 'ivory tower' planning?

2.9. Costing and cost control

Are cost standard set?

Are they adequate for control purposes?

Are report and systems used by those responsible?

Cost control checklist

Operational costs :

- unit direct labour
- unit direct material
- consumables
- overhead
- overtime costs

3. MARKETING

3.1 Marketing strategic and objectives

Check for declining or fluctuating :

- Sales trends
- Gross profit margins

Is adequate market research undertaken?

Is market testing done before a services is launched?
Is a detailed marketing plan prepared?
Is the marketing and strategic plan compatible?
Is the current budget consistent with the marketing and strategic plan?
Are short-term sales targets set?
Are budgets set for individual staff?
Are marketing costs regularly reviewed?
Is promotion expenditure measured against sales generation?
Does the entity use product-market segment management?
Are there underdeveloped market niches?

- service
- geographic

Which service items are in the lowest 10-20% of sales volume?

- How many are declining?
- How many should be deleted?

What are the entity's promotion objectives?
Are they relevant?
Is the promotion and media mix effective?
How many days work is in hand?
Check type and frequency of customer complaints.

3.2. Vulnerability

Check for marketing mix awareness :

- products
- place
- price
- promotion
- packaging
- focus

Is market share known?
Is it growing or declining?
Cost or ease of entry for a competitor?
Does the entity have current information on competitors?
Check position of current service lines in the life cycle.
What is the entity's core technology?
Is it vulnerable to changes in technology?
What should be its response?
Check incidence of quality or warranty problems.
Are service fees keeping pace with inflation?
when were charge rates last revised?
What are the customers' view of the enterprise?
What is its sustainable competitive advantage?

3.3. Pricing policies

Is pricing based on :

- customer perceptions of value?
- internal costs?
- competitor prices?

What are the quotation failure rates?
Check the cost structure and cost allocation methods.

3.4. Customer or industry dependence

How many customers account for 80% of the sales?

How much of sales volume is in industry groups that are :
- declining?

Subject to cyclical fluctuations (e.g. building and agriculture)?

3.5. Research and development

Review service development contribution and performance.

Are R and D planning and priorities geared to market opportunities?

Does R and D liase closely with Marketing?

Discribe the project review system : does it enable early detection of project or developments that should be abandoned?

Summarise performance (strengths and weaknesses) of the Marketing function.

4. SERVICE DELIVERY

4.1. Level of productivity

Obsolete equipment or methods?

Ratio of chargeable hours total paid hours?

Check for increasing unallocated time.

Suitability and availability of staff?

Workload planning : check for evidence of Unfulfilled client requirements.

EXTERNAL ANALYSIS
Diagnostic checklist for the LPD

1. Social factors

Trends

Consumer values

Changing attitudes of society

Organised consumer groups and pressure groups

2. Economic factors

Cyclical fluctuations

Population trends

Productivity and labour cost trends

Availability of staffs

Availability of materials

Demand factors:
- Average disposable incomes

3. Technology

New product being developed

Changes affecting end use of products
Risk of obsolescence
Changes to packaging
Relative changes within industry sectors

4. Government

Assistance program
Legislation
Commercial regulation
Taxes

5.Demographic factors
Changes in the structure of the population
(e.g. impact of the declining birth rate and an ageing population)
Population drift to and between capital cities

6. Customers and suppliers
Their perceptions of the enterprises

7. Competitors
Competitors strengths and weaknesses:

- Finance and financial strength
- Product range
- Product quality
- Marketing and channels of distribution
- Market share
- Price structure

APPENDIX 6:
DATA USED FOR SWOT ANALYSIS

Table 1
General Indicators of LPD Mas

Indicators	1986	1996	2001
1. Total Assets (million Rp)	6.4	381.5	7055
2. Total Equity (million Rp)	2	28.6	373.4
3. Loan to Deposit Ratio (LDR)	1.8	1.1	0.87
4. Bank deposits (million Rp)	-	34.8	1560
5. Profits (million Rp)	1	14	427.9

Source: LPD Mas, Financial Reports, 1986, 1996 and 2001

Table 2
Selected Financial Indicators of LPD Mas of Ubud, Gianyar, Bali
1996 and 2001

Indicators	December 1996	December 2001
• Efficiency:		
Operating cost ratio	0.23	0.22
Salaries as percentage of average loans outstanding	0.02	0.02
• Productivity:		
Outstanding loans/staff (million Rp)	45.4	477.1
Borrowers/staff	104	146
Savings/staff (million Rp)	5	14.5
Savers/staff	204	488
Time deposit/staff (million Rp)	35.8	398.7
Depositor/staff	20	46
• Profitability:		
Return on Assets (%)	4.9	7
Return on Equity (%)	55.7	143.9
• Self-sustainability:		
Operational self-sufficiency	87.4	106.4
Financial self-sufficiency	-	-

Table 3
Outreach of LPD Mas of Ubud, Gianyar, Bali, 1996 and 2001

Indicators	1996	2001
Clients and Staff outreach:		
• Number of borrowers	764	1607
• Number of savers	1,429	5377
• Number of depositors	138	513
• Number of staff:	7	11
• Percentage of total target clientele serviced (%)	-	15.8
Loan outreach:		
• Volume of outstanding loans (million Rp)	317.9	5,248
• Average loans per borrower (million Rp)	0.41	3.26
• Average loans per borrower as percentage of GRDP per capita[1)]	-	0.82
Saving/Deposits outreach:		
• Volume of savings (million Rp)	34.9	1,593.6
• Average savings per saver (million Rp)	0.24	0.99
• Volume of time deposits (million Rp)	250.8	4,385.7
• Average deposits per depositor ((million Rp)	1.8	8.5

Note: [1)] Based on GRDP per capita of Ubud sub-district at current price in 2001 was Rp 3.95million

Source: LPD Mas of Ubud, various financial reports, 1995 and 2001 (computed by the author)

Table 4
General Indicators of LPD Kerta

Indicators	1996	2001
1. Total Assets (million Rp)	614.2	1401
2. Total Equity (million Rp)	53.9	190.8
3. Loan to Deposit Ratio (LDR)	1.03	1.12
4. Bank deposits (million Rp)	35.3	74.4
5. Profits (million Rp)	37.4	80.2

Source: LPD Kerta, Financial Reports, 1996 and 2001

Table 5
Selected Financial Indicators of LPD Kerta of Payangan, Gianyar, Bali, 1996 and 2001

Indicators	December 1996	December 2001
• Efficiency:		
Operating cost ratio	0.27	0.34
Salaries as percentage of average loans outstanding	0.04	0.04
• Productivity:		
Outstanding loans/staff (million Rp)	59.8	156.6
Borrowers/staff	62	62
Savings/staff (million Rp)	11.1	34.1
Savers/staff	116	128
Time deposit/staff (million Rp)	46.6	105
Depositor/staff	22	24
• Profitability:		
Return on Assets (%)	6.7	6.2
Return on Equity (%)	78.6	46.5
• Self-sustainability:		
Operational self-sufficiency	0.98	0.83
Financial self-sufficiency	-	-

Table 6
Outreach of LPD Kerta of Payangan, Gianyar, Bali, 1996 and 2001

Indicators	1996	2001
Clients and Staff outreach:		
• Number of borrowers	557	497
• Number of savers	1049	1030
• Number of depositors	197	192
• Number of staff:	9	8
Male	7	6
Female	2	2
• Percentage of total target clientele serviced (%)	-	10.3
Loan outreach:		
• Volume of outstanding loans (million Rp)	538.1	1,253.2
• Average loans per borrower (million Rp)	0.96	2.5
• Average loans per borrower as percentage of GRDP per capita[1)]	-	1.1
Saving/Deposits outreach:		
• Volume of savings (million Rp)	100.5	273.3
• Average savings per saver (million Rp)	0.095	0.27
• Volume of time deposits (million Rp)	420	840
• Average deposits per depositor ((million Rp)	2.1	4.37

Note: [1)] Based on GRDP per capita of Payangan sub-district at current price in 2001 was Rp 2.16million

APPENDIX 7:
QUESTIONNAIRES FOR MFI MANAGEMENT

AN ASSESSMENT OF PERFORMANCE AND SUSTAINABILITY OF MICROFINANCE INSTITUTIONS:
A Case Study of Village Credit Institutions of Gianyar, Bali, Indonesia

This interview is being conducted to produce a thesis and other publications on the subject of An Assessment of Performance and Sustainability of Microfinance Institutions: A Case Study of Village Credit Institutions of Gianyar, Bali, Indonesia*. I would be grateful if you would volunteer to spare the time to assist in this project, by granting an interview and agreeing to observation which touch upon certain aspects of this topic. No more than 1 hour will be required. Thank you.*

Name of Institution	
Address	
Ownership of Institution	
Date when established	
Name of person interviewed	
Position in Institution	
Formal education	1. No schooling 2. Not completed primary school but at level ..… (specify) 3. Primary School 4. Junior High School (SMP) 5. Senior High School (SMU) 6. Diploma (I, II, III) 7. University
Informal education	1. Vocational Training 2. Job Training 3. Special Training (specify) 4. Other (specify)
Age/Gender of Person Interviewed	
Marital status	1. Married 2. Single 3. Widow 4. Separated

I. General information

1. Distance of institution to capital city of regency _______________ Km

2. Office ownership
   [1] Own [2] Renting [3] Government building

[4] Others (specify)

3. Main office equipment used by the institution:

Type	Number	Status*
1. Furniture		
2. Filing cabinet		
3. Typing machine		
4. Computer		
5. Calculator		
6. Safety box		
7. Other (specify)		

* 1. Own 2. Renting 3. Government supported 4. Other (specify)

4. a. Is the equipment adequate to support the operations of the institution?

[1] Yes [2] No

b. If "No", what are the supporting tools/equipment that is required in the short-term?

II. Skills and training

5. How many people are normally employed in the institution?

Employee category	Number of employee Or Hours/week
1. Full time (no.)	
2. Part time (est. hrs/week)	

6. What is the level of age, gender, education, and marital status of the people employed?

Name of *full time* employee	Age	Gender	Education	Marital status
1.				
2.				
3.				
Name of *part time* employee	**Age**	**Gender**	**Education**	**Marital status**
4.				
5.				

7. Describe the main role/occupation for each employee:

____

____

____

8. What general management skills are available:
   a. Banking management
   b. Financial management
   c. Personnel management
   d. Other (*please specify*)

9 a. What abilities/skills are available in the community to ensure implementation?

____

____

____

b. Are they enough? 1. [Yes] [2] No

c. If not, what else is needed

____

10. What in-house/external training is available to provide for any skills shortfall?
    a. In-house:

    ____

    ____

    b. External:

    ____

    ____

III. Financial Performance

11 a. What is the main source of initial capital for the institution?

____

____

b. How much capital was received initially?

____

12 a. What is the main source of working capital for the institution?

____

____

b. How much working capital was received initially?

____

13. a. Are there any difficulties to get additional working capital for the institution?

[1] Yes [2] No

b. If the answer is “No”, continue to # 14. If the answer is “Yes”, why?

____

____

14. a. Have *Income Statements and Balance Statement* been prepared for the institution?

[1] Yes [2] No

b. If so, how frequently are they prepared? ____________________________
c. Prepared by whom? ____
d. *Request a copy if available*

15. a. Is an external audit carried out for the institution?

[1] Yes [2] No

b. If so, how frequently? ____

16. Profile of *main items of expenditure* over time:

	Year 1 (Rp)	**Year 2 (Rp)**	**Year 3 (Rp)**
1. Capital expenditure			
2. Operating expenditure			
3. Total Expenditure			

17. a. Profile of *main revenue items* over time:

	Year 1 (Rupiah)	Year 2 (Rupiah)	Year 3 (Rupiah)
Revenue			

b. Is this revenue:
[1] Seasonal: ____

[2] Year around: ____

18. Profile of Net income over time:

	Year 1 (Rupiah)	Year 2 (Rupiah)	Year 3 (Rupiah)
Net Income			

19. a. Do you undertake depreciation of your capital equipment?

[1] Yes [2] No

b. If the answer is “Yes”, what annual rate of depreciation is used?

____

20. During the last 12 months, in what ways did you use the *net income* of this institution?

[1] reinvest (for additional working capital)
[2] buy equipment for the institution
[3] save
[4] other (specify)

IV. Credit

21. What are the requirements for obtaining loans from your institution?

	Rank
Collateral	
Character	
Feasibility of business	
References	
Other (specify)	

22. Describe the main steps involved in obtaining a loan from your institution (*request a flow chart if any*)?

____
____
____

23. How long is the period between receiving a loan proposal and disbursement of loan funds?

____

24. What are the rules/regulations used by the institution to allocate loans to clients?

____
____
____

25 a. Is there any additional “policy” used to allocate loans other than those clearly specified in rules and regulations?

[1] Yes [2] No

b. If the answer “yes”, what are the policies?

____
____

26. a. Are there any related institutions that supervise loan disbursement from your institution?

[1] Yes [2] No

b. If the answer "yes", what are the institutions?

____
____

27. Who are the main clients of the institution?

[1] Members of the institution
[2] Potential members of the institution
[3] Others (specify) ________

28. Number of members/clients of the institution:

Occupation	Number
1. Farmers	
2. Small traders	
3. Workers/laborers	
4. Handicraft industries	
5. Other (specify)	
Total clients	

29. Number of *borrowers* and *savers* of the institution:

Occupation	Number of borrowers	Number of savers
1. Farmers		
2. Small traders		
3. Workers/laborers		
4. Small-scale industries		
5. Other (specify)		
Total		

30. Type, value of loans, and number of borrowers:

Type of loans	Value of loans	Number of borrowers
1. Weekly loan		
2. Monthly loan		
3. Other (specify)		

31. Lowest, highest, and average values of loans and savings

	Loans (Rp)	Savings (Rp)
1. The lowest		
2. The highest		
3. Average		

32. Value of loans and savings:

Period	Loans (Rp)	Savings (Rp)
Year 1		
Year 2		
Year 3		

33. Repayment rate of the institution

Period	Repayment rate (%)
Year 1	
Year 2	
Year 3	
Year 4	

34. a. Do clients face any difficulty repaying the loan to the institution in the last loan?

[1] Yes (Go to # 35) [2] No (Go to # 36) [3] Don't know (Go to # 36)

b. If yes, what caused your repayment problems?

1. Loan activity was not profitable
2. The client or others in his/her family has been sick
3. The client used some of the loan for food or other items for the household
4. The client did not get paid back in time
5. Bad character of the client
6. Other (specify)

35. What efforts have been made to improve the repayment rate?

___
___
___

36. Savings rate of the members of the institution:

Period	Savings rate (%)
Year 1	
Year 2	
Year 3	
Year 4	

37. What efforts have been made to improve the saving rate?

____

____

____

38. a. Have initial and working capital made available to the institution met the need of clients?

[1] Yes [2] No

b. Explain why?

____

____

____

V. Management

39. Who are the key players?

a. In ownership:

____

b. In day-to-day management:

____

40. In equipment purchasing arrangements, who provided

a. The finance?

____

b. Business advice?

____

c. Technical advice?

____

Other support?

____

41. What monitoring/evaluation is in place?

a. Financial:______________________________
b. Skills: ______________________________
c. Other:______________________________
d. Is any other monitoring/evaluation needed?
____

42. a. Who provides an institution monitoring service?
____

b. How frequently?
____

43. a. What steps are taken to maintain the equipment of the institution?
____
____

b. By whom?	[1] Managers [2] Outside authorities [3] Other (specify)______________
c. Financed by?	[1] Cashflow [2] Grants [3] Outside authorities [4] Other (*specify*)______________

44. a. What developments have been undertaken by the institution in the last two years?______________________________
____
____

b. Was this part of a development plan?
[1] Yes [2] No

c. What difficulties were involved?
[1] Access to finance
[2] Technical skills
[3] Management
[4] Coordination
[5] Consultation

45. Please comment on how the institution fits with the other community/organization goals such as ceremonies, attending community meetings, etc.?

____

____

____

46. Do you have any special strategies or alliances (e.g. with other institutions or organization, etc.)?

____

____

____

VI. Future of the Institution

47. a. Does the institution face a tight competition with other microfinance institutions?

    [1] Yes [2]

    b. If "Yes", what strategies used to deal with the competition?

____

____

____

48. According to your point of view, name **three** advantages of the institution?

    a. Lower interest rate than other informal sources of credit (informal lenders)
    b. Steady source of working capital
    c. Training or technical assistance
    d. Better services than other competitor institutions
    e. Efficiency, compared to banks or other sources
    f. Easier guarantees than loan alternatives
    g. No collateral
    h. Other (specify)

49. According to your point of view, name **three** disadvantages of the institution?

    a. High interest rates
    b. Size of loans too small
    c. Loan cycle too long or too short
    d. Repayment policy (frequency, amount)
    e. Guarantee policies
    f. Transaction costs for client (such as slow disbursement)
    g. Lack of grace period
    h. Forced savings
    i. Dislike behaviour/attitude of loan officer or other program personnel
    j. Other (specify)

50. If you could change anything about the institution to make it operate better, what would you change and why?

____

____

____

____

Thank you for your time and assistance

APPENDIX 8:
QUESTIONNAIRES FOR CLIENTS OF MFI

AN ASSESSMENT OF PERFORMANCE AND SUSTAINABILITY OF MICROFINANCE INSTITUTIONS:
A Case Study of Village Credit Institutions of Gianyar, Bali, Indonesia

This interview is being conducted to produce a thesis and other publications on the subject of An Assessment of Performance and Sustainability of Microfinance Institutions: A Case Study of Village Credit Institutions of Gianyar, Bali, Indonesia*. I would be grateful if you would volunteer to spare the time to assist in this project, by granting an interview and agreeing to observation which touch upon certain aspects of this topic. No more than 1 hour will be required. Thank you.*

Name of Enterprise	
Address	
Ownership of Enterprise	
Date when established	
Name of person interviewed	
Position in Enterprise	
Formal education	1. No schooling 2. Not completed primary school but at level ..… (specify) 3. Primary School 4. Junior High School (SMP) 5. Senior High School (SMU) 6. Diploma (I, II, III) 7. University
Informal education	1. Vocational Training 2. Job Training 3. Special Training (specify) 4. Other (specify)
Age/Gender of Person Interviewed	
Marital status	1. Married 2. Single 3. Widow 4. Separated

I. Historical aspects

1. What is the legal status of enterprise:
   [1] Pty Ltd Company
   [2] Trust
   [3] Partnership
   [4] Cooperative

[5] Other (specify)

2. Who owns the land on which the enterprise operates?

___

3. Please give a detailed description of the activity the enterprise operates (e.g. handicraft)

___
___
___

4. What were the reasons for establishing the enterprise?

___
___
___

II. Consultation issues:

5. What consultation was undertaken to set up the enterprise *(record most important first)?*
With whom, why and results achieved:

___
___
___

6. What consultative mechanisms are used?

[1] Mode:
___

[2] Frequency:
___

III. Physical attributes of the enterprise:

7. What was the previous activity on site?

a. If this is a new enterprise, what was the previous activity on site: ___

b. If an existing similar business was purchased, was it:
[1] in good condition
[2] in average condition
[3] run down

8. What are the main **goods produced** by the enterprise?

[1] ____________
[2] ____________
[3] ____________

9. a. In Q8 above, if goods are produced, are the main goods produced:

[1] in the traditional way
[2] using modern technology
[3] a mixture of both

b. Are goods produced:
[1] in home
[2] in a purpose built facility
[3] other (*please describe*)

c. Are they unique to the area?
[1] Yes [2] No

d. If so, how?
____
____
____

10. Is the current infrastructure (plant/equipment) for the enterprise:
[1] underutilized
[2] obsolete
[3] adequate
[4] good
[5] other (*please describe*)

11. Is there a preventative maintenance program on the infrastructure (plant/equipment)?

[1] Yes [2] No

12. What are the main inputs used in the enterprise?
____

13. For the main inputs used in the enterprise:

[1] one source
[2] multiple sources

14. What factors affect:

a. the price of inputs?

____

____

b. the quality of inputs?

____

____

c. the availability of inputs?

____

____

V. Financial

15. a. What is the main source of (initial and working) capital for the enterprise?

____

____

b. How much the capital and over what period of time?

____

____

c. What rate of interest and what other fees?

____

____

16. a. Does the enterprise obtain loans from other institutions?

[1] Yes [2] No

b. If "Yes", how much and why?

____

____

17. Are there any difficulties to get additional working capital for the enterprise?

____

____

____

18. a. Have *Income Statements and Balance Statement* been prepared for the enterprise?

[1] Yes [2] No

b. If so, how frequently are they prepared?

____

c. Prepared by whom?

d. *Request a copy if available*

19 a. Is an external audit carried out for the enterprise?

[1] Yes [2] No

b. If so, how frequently?

20. a. Is an *Investment analysis* carried out for the enterprise?

[1] Yes [2] No

b. If so, how frequently?

c. Carried out by whom?

d. What was the result?

21. a. Has a *Profile of development costs over time* been prepared for the enterprise?

[1] Yes

[2] No

b. Prepared by whom?
c. *Request a copy if available*.

22. Profile of *main items of expenditure* over time:

	Year 1 (Rp)	Year 2 (Rp)	Year 3 (Rp)
1. Capital expenditure			
2. Operating expenditure			
3. Total Expenditure			

23. a. Profile of *main revenue items* over time:

	Year 1 (Rupiah)	Year 2 (Rupiah)	Year 3 (Rupiah)

Revenue			

b. Is this revenue:
[1] Seasonal: ____

[2] Year around: ____

24. Profile of *net income* over time:

	Year 1 (Rupiah)	Year 2 (Rupiah)	Year 3 (Rupiah)
Net Income			

VI. Skills and training

25. How many people are normally employed in the enterprise?

Employee category	Number of employee or Hours/week
1. Full time (no.)	
2. Part time (est. hrs/week)	
3. Seasonal maximum (no.)	

26. What is the level of age, gender, and education of the people employed?

Name of *full time* employee	Age	Gender	Education
1.			
2.			
3.			
4.			
5.			

Name of *part time* employee	Age	Gender	Education
6.			
7.			
8.			
9.			

Name of *seasonal* employee	Age	Gender	Education
10.			
11.			
12			
13.			

27. What general management skills are available:
    e. Marketing management
    f. Manufacturing production
    g. Resource management
    h. Personnel management
    i. Other (*please specify*)

28. a. What abilities/skills are available in the enterprise to ensure implementation?
    ____
    ____

    b. Are they enough? [1] Yes [2] No

    c. If not, what else is needed
    ____

29. What in-house/external training is available to provide for any skills shortfall?

    [1] In-house:
    ____
    [2] External:
    ____

VII. Management

30. Who are the key players?
    [1] In ownership: ____

    [2] In strategic management: ______________________________________
    [3] In day-to-day management: _____________________________________

31. What are the management arrangements for the enterprise?
    Hands-on by the owners through a:
    [1] Co-operative
    [2] Manager/owner
    [3] Other

32. a. If the owners adopt a hands-on approach to running the enterprise, which people meet:

    1. Name …………………………………… Position …………………
    2. Name …………………………………… Position …………………

    b. How often do they meet?
    ____

c. Are they effective/efficient?
[1] Yes
[2] No

33. In the land/infrastructure (plant/equipment) purchasing arrangements, who provided

[1] The finance?____
[2] Business advice?
____
[3] Technical advice?____
[4] Other support?____

34. What monitoring/evaluation is in place?

[1] Financial:
____
[2] Skills:____
[3] Quality control:
____
[4] Other:
____
[5] Is any other monitoring/evaluation needed?
____

35. a.Who provides an enterprise monitoring service?
____
b. How frequently?
____

36. a. What steps are taken to maintain the land/infrastructure (plant/equipment) of the enterprise?
____
____
____
b. By whom?
Managers
Traditional owners
Outside authorities
Other (specify)

c. Financed by?

Cashflow
Grants
Outside authorities
Other (*specify*)

37. What resources are aware of to maintain and develop your enterprise, **that you <u>do not</u> make use of?**____

____

____

38. a. What developments have been undertaken by the enterprise in the last two years? ____

____

____

b. Was this part of a development plan?

[1] Yes [2] No

c. What difficulties were involved?

Access to finance: ______________________

Technical skills: ______________________

Management: ______________________

Coordination: ______________________

Consultation: ______________________

39. Please comment on how the enterprise fits with the other community/organization goals such as ceremonies, attending community meetings, etc.?

____

____

____

40. How do you adjust your management and labour force arrangements to allow for absences from work for traditional reasons?

____

____

41. Do you have any special trading strategies or alliances (e.g. with other enterprises, etc.)?

____

____

VIII. Marketing issues:

42. a. Was any market research done:
- prior to establishing the enterprise
- after establishing the enterprise
- none was done

b. By whom?
____

43. a. Are short term sales targets set:

[1] Yes [2] No

b. By whom? ____

c. Are they regularly reviewed:

[1] Yes [2] No

d. By whom? ____

44. a. Are marketing costs regularly reviewed, particularly in the light of sales:

[1] Yes [2] No

b. By whom?
____

45. a. Has the enterprise identified any underdeveloped market niches:

[1] Yes [2] No

b. What are they?
____

46. Are some products underperforming to the extent that they should be dropped:

[1] Yes [2] No

47. a. Is any advertising/promotion undertaken:

[1] Yes [2] No

b. Is it effective?
[1] Yes [2] No

48. a. Do you have an effective distribution system for goods/transport system for tourism:
[1] Yes [2] No

b. Please explain?

____
____
____

49. What competition does the enterprise have?

____
____
____

50. What is sustainable competitive advantage?

____
____
____

51. a. Is the enterprise vulnerable to changes in technology:

[1] Yes [2] No
b. Please explain?

____
____

52. When were prices last reviewed?

[1] within the last 3 months
[2] within the last 3 to 12 months
[3] longer

53. How are the goods sold?
[1] Direct export
[2] Wholesale agent
[3] Other outlets
[4] Local tourism market
[5] Other

54. Do you have any special trading strategies or alliances (e.g. with other enterprises, etc.)?

____

____

____

<u>IX. Impact of Microfinance Institution on Client</u>

55. a. Did you face any difficulty repaying your loan to the program in the last loan cycle?

1 = Yes	2 = No
(Go to # 74b)	(Go to # 75)

b. If yes, what caused your repayment problems?

[1] Loan activity was not profitable
[2] I or others in my family has been sick
[3] Used some of the loan for food or other items for the household
[4] Sold on credit and did not get paid back in time
[5] Other (specify)

56. Name **<u>three</u>** things you like most about the institution?

[1] Lower interest rate than other informal sources of credit (informal lenders)
[2] Steady source of working capital
[3] Training or technical assistance
[4] Other financial services, such as savings
[5] Efficiency, compared to banks or other sources
[6] Easier guarantees than loan alternatives
[7] Other (specify)

57. Name **<u>three</u>** things you like least about the institution?

[1] High interest rates
[2] Size of loans too small
[3] Loan cycle too long or too short
[4] Repayment policy (frequency, amount)
[5] Guarantee policies
[6] Transaction costs for client (such as slow disbursement)
[7] Lack of grace period
[8] Forced savings
[9] Dislike behaviour/attitude of loan officer or other program personnel
[10] Other (specify)

58. If you could change anything about the institution to make it operate better, what would you change and why?

____
____
____
____
____

Thank you for your time and assistance

APPENDIX 9:
COMPUTER RESULTS OF MANN-WHITNEY TEST

Ranks

	REGION	N	Mean Rank	Sum of Ranks
REPAYMENT-RATE	indust	91	79.98	7278.50
	agri	62	72.62	4502.50
	Total	153		
DEL-BORROWER-RATIO	indust	91	75.58	6877.50
	agri	62	79.09	4903.50
	Total	153		
DEBT-TO-EQUITY-RATIO -2	indust	83	72.98	6057.00
	agri	57	66.89	3813.00
	Total	140		
CAPITAL-ADEQUACY-RATIO-WEIGHTED	indust	91	74.37	6768.00
	agri	62	80.85	5013.00
	Total	153		

Test Statistics[a]

	REPAYMENT-RATE	DEL-BORROWER-RATIO	DEBT-TO-EQUITY-RATIO-2	CAPITAL-ADEQUACY-RATIO-WEIGHTED
Mann-Whitney U	2549.500	2691.500	2160.000	2582.000
Wilcoxon W	4502.500	6877.500	3813.000	6768.000
Z	-1.064	-.501	-.872	-.888
Asymp. Sig. (2-tailed)	.288	.616	.383	.374

a. Grouping Variable: REGION

Ranks

	REGION	N	Mean Rank	Sum of Ranks
BORROWERS-PER-STAFF	indust	91	72.58	6604.50
	agri	62	83.49	5176.50
	Total	153		
OUTSTANDING PER STAFF	indust	91	85.34	7766.00
	agri	62	64.76	4015.00
	Total	153		
SAVERS PER STAFF	indust	91	81.30	7398.50
	agri	62	70.69	4382.50
	Total	153		
VALUE OF SAVINGS PER STAFF	indust	91	85.46	7777.00
	agri	62	64.58	4004.00
	Total	153		
DEPOSITOR-PER-STAFF	indust	91	78.77	7168.00
	agri	62	74.40	4613.00
	Total	153		

Test Statistics[a]

	BORROWERS-PER-STAFF	OUTSTANDING PER STAFF	SAVERS PER STAFF	VALUE OF SAVINGS PER STAFF	DEPOSITOR-PER-STAFF
Mann-Whitney U	2418.500	2062.000	2429.500	2051.000	2660.000
Wilcoxon W	6604.500	4015.000	4382.500	4004.000	4613.000
Z	-1.496	-2.821	-1.455	-2.862	-.599
Asymp. Sig. (2-tailed)	.135	.005	.146	.004	.549

a. Grouping Variable: REGION

Ranks

	REGION	N	Mean Rank	Sum of Ranks
DEPOSITS-PER-STAFF	indust	83	77.57	6438.00
	agri	57	60.21	3432.00
	Total	140		
OPERATING-COST-RATIO	indust	91	75.23	6846.00
	agri	62	79.60	4935.00
	Total	153		
SALARY/AVERAGE-OUTSTANDING	indust	91	71.25	6484.00
	agri	62	85.44	5297.00
	Total	153		
RETURN-ON-ASSET-1	indust	91	79.20	7207.00
	agri	62	73.77	4574.00
	Total	153		

Test Statistics[a]

	DEPOSITS-PER-STAFF	OPERATING-COST-RATIO	SALARY/AVERAGE-OUTSTANDING	RETURN-ON-ASSET-1
Mann-Whitney U	1779.000	2660.000	2298.000	2621.000
Wilcoxon W	3432.000	6846.000	6484.000	4574.000
Z	-2.488	-.598	-1.944	-.743
Asymp. Sig. (2-tailed)	.013	.550	.052	.457

a. Grouping Variable: REGION

Ranks

	REGION	N	Mean Rank	Sum of Ranks
RETURN-ON-EQUITY	indust	44	33.66	1481.00
	agri	22	33.18	730.00
	Total	66		
OPERATING-SELF-SUFFICIENCY2	indust	91	80.70	7344.00
	agri	62	71.56	4437.00
	Total	153		
FINANCIAL-SELF-SUFFICIENCY2	indust	44	33.91	1492.00
	agri	22	32.68	719.00
	Total	66		
BORROWERS	indust	91	79.25	7212.00
	agri	62	73.69	4569.00
	Total	153		
SAVERS	indust	91	83.28	7578.50
	agri	62	67.78	4202.50
	Total	153		

Test Statistics[a]

	RETURN-ON-EQUITY	OPERATING-SELF-SUFFICIENCY2	FINANCIAL-SELF-SUFFICIENCY2	BORROWERS	SAVERS
Mann-Whitney U	477.000	2484.000	466.000	2616.000	2249.500
Wilcoxon W	730.000	4437.000	719.000	4569.000	4202.500
Z	-.095	-1.252	-.245	-.762	-2.124
Asymp. Sig. (2-tailed)	.924	.210	.807	.446	.034

a. Grouping Variable: REGION

Ranks

	REGION	N	Mean Rank	Sum of Ranks
DEPOSITOR	indust	91	80.64	7338.00
	agri	62	71.66	4443.00
	Total	153		
NUMSTAFF	indust	91	84.22	7664.00
	agri	62	66.40	4117.00
	Total	153		
OUTSTANDING-LOANS	indust	91	86.22	7846.00
	agri	62	63.47	3935.00
	Total	153		
AVERAGE-LOANS-PER-BORR	indust	91	89.44	8139.00
	agri	62	58.74	3642.00
	Total	153		
SAVINGS	indust	91	87.49	7962.00
	agri	62	61.60	3819.00
	Total	153		

Test Statistics[a]

	DEPOSITOR	NUMSTAFF	OUTSTANDING-LOANS	AVERAGE-LOANS-PER-BORR	SAVINGS
Mann-Whitney U	2490.000	2164.000	1982.000	1689.000	1866.000
Wilcoxon W	4443.000	4117.000	3935.000	3642.000	3819.000
Z	-1.231	-2.474	-3.118	-4.207	-3.549
Asymp. Sig. (2-tailed)	.218	.013	.002	.000	.000

a. Grouping Variable: REGION

Ranks

	REGION	N	Mean Rank	Sum of Ranks
SAVING-PER-SAVER	indust	91	86.40	7862.00
	agri	62	63.21	3919.00
	Total	153		
DEPOSITS-PER-DEPOSITOR	indust	83	80.67	6695.50
	agri	57	55.69	3174.50
	Total	140		

Test Statistics[a]

	SAVING-PER-SAVER	DEPOSITS-PER-DEPOSITOR
Mann-Whitney U	1966.000	1521.500
Wilcoxon W	3919.000	3174.500
Z	-3.177	-3.580
Asymp. Sig. (2-tailed)	.001	.000

a. Grouping Variable: REGION

APPENDIX 10:
COMPUTER RESULTS OF LOGISTIC ANALYSIS

Case Processing Summary

Unweighted Cases[a]		N	Percent
Selected Cases	Included in Analysis	152	98.7
	Missing Cases	2	1.3
	Total	154	100.0
Unselected Cases		0	.0
Total		154	100.0

a. If weight is in effect, see classification table for the total number of cases.

Dependent Variable Encoding

Original Value	Internal Value
0	0
1	1

Categorical Variables Codings

		Frequency	Paramete (1)
DUMMY-REGIONS	0	61	1.000
	1	91	.000
WEALTHINDEX	0	90	1.000
	1	62	.000

Block 0: Beginning Block

Classification Table[a,b]

			Predicted		
			BI-REPAYMENT-RATE		Percentage Correct
	Observed		0	1	
Step 0	BI-REPAYMENT-RATE	0	88	0	100.0
		1	64	0	.0
	Overall Percentage				57.9

a. Constant is included in the model.

b. The cut value is .500

Variables in the Equation

		B	S.E.	Wald	df	Sig.	Exp(B)
Step 0	Constant	-.318	.164	3.758	1	.053	.727

Variables not in the Equation[a]

			Score	df	Sig.
Step 0	Variables	OUTS2001	4.045	1	.044
		BORROWER	4.131	1	.042
		SAVERS	6.849	1	.009
		NSTAFF	3.945	1	.047
		WEALTH(1)	.001	1	.972
		DUMMY(1)	.053	1	.819

a. Residual Chi-Squares are not computed because of redundancies.

Block 1: Method = Enter

Omnibus Tests of Model Coefficients

		Chi-square	df	Sig.
Step 1	Step	9.842	6	.131
	Block	9.842	6	.131
	Model	9.842	6	.131

Model Summary

Step	-2 Log likelihood	Cox & Snell R Square	Nagelkerke R Square
1	197.070	.063	.084

Hosmer and Lemeshow Test

Step	Chi-square	df	Sig.
1	18.357	8	.019

Contingency Table for Hosmer and Lemeshow Test

		BI-REPAYMENT-RATE = 0		BI-REPAYMENT-RATE = 1		
		Observed	Expected	Observed	Expected	Total
Step 1	1	10	12.500	5	2.500	15
	2	13	10.388	2	4.612	15
	3	11	9.566	4	5.434	15
	4	10	9.069	5	5.931	15
	5	11	8.690	4	6.310	15
	6	4	8.210	11	6.790	15
	7	8	7.858	7	7.142	15
	8	10	7.491	5	7.509	15
	9	3	7.017	12	7.983	15
	10	8	7.211	9	9.789	17

Classification Table[a]

	Observed		Predicted		
			BI-REPAYMENT-RATE		Percentage Correct
			0	1	
Step 1	BI-REPAYMENT-RATE	0	74	14	84.1
		1	39	25	39.1
	Overall Percentage				65.1

a. The cut value is .500

Variables in the Equation

		B	S.E.	Wald	df	Sig.	Exp(B)
Step 1[a]	OUTS2001	.000	.000	.084	1	.772	1.000
	BORROWER	.000	.001	.053	1	.818	1.000
	SAVERS	-.001	.001	2.646	1	.104	.999
	NSTAFF	.004	.110	.001	1	.972	1.004
	WEALTH(1)	-.070	.378	.034	1	.853	.932
	DUMMY(1)	-.303	.394	.594	1	.441	.738
	Constant	.516	.592	.761	1	.383	1.676

a. Variable(s) entered on step 1: OUTS2001, BORROWER, SAVERS, NSTAFF, WEALTH, DUMMY.