Indonesia: a Regional Development Bank linked with village-based non-bank financial institutions*

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ASIA

BALI

REGIONAL DEVELOPMENT BANK

July 2007

* This case study research, thanks to funding from the Ford Foundation, is a working document that is part of a multi-country review of successful innovations in improving access to financial services for poor populations in rural areas through linkages between the formal financial sector and informal financial institutions. The global review, coordinated by the Rural Finance Group of the Food and Agriculture Organization (FAO) of the United Nations, examines 13 cases in Africa, Asia and Latin America. Results from multi-country study will be published in a forthcoming book in early 2007.

Acronyms

BKK	Badan Kredit Kecamatan
BKS-LPD	Badan Kerjasama LPD
BPD	Bank Pembangunan Daerah Bali
BPR	Bank Pembangunan Rakyat
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH
IDR	Indonesian rupiah
KPKM	Kredit Pengembangan Kelompok Mandiri
LDKP	Lembaga Dana dan Kredit Pedesaan -Village credit fund institution
LDR	Loan Deposit Ratio
LKP	Lembaga Kredit Pedesaan
LPD	Lembaga Perkreditan Desa
NCL	Non-collectible loan ratio
PLPDK	Pusat LPD Kabupaten
ROA	Return on Assets
ROE	Return on Equity

Indonesia: a Regional Development Bank linked with village-based non-bank financial institutions

Abstract: *The case of financial linkages between the Regional Development Bank (BPD) and village credit institutions (LPDs) in the province of Bali demonstrates the impact of banking policies, regulation and supervision on the nature, and to a certain extent, the level of success, of formal and informal financial sector linkages. BPD, mandated by government decree, supervises and provides management training to LPDs in the province. Although other financial ties exist between the BPD and LPDs, the main purpose of the relationship appears to be the transfer of knowledge and assurance of good financial health. The author claims this relationship to be a success but cautions against certain rigidities of the model, e.g., restrictions for an LPD to have saving accounts with other financial institutions.*

Introduction

This report presents the major findings of a study of financial linkages between the Regional Development Bank (*Bank Pembangunan Daerah Bali,* or BPD) and Village Credit Institutions (*Lembaga Perkreditan Desa,* or LPD) in the province of Bali, Indonesia. This study addresses the main drivers, the challenges, and the costs and benefits of these linkage arrangements. Several sources of information were used, including relevant publications, reports, statistics from previous studies and in-depth interviews with selected stakeholders and LPDs.

BPD is a commercial bank with a regional development focus, owned jointly by the provincial and district governments. In this study it is referred to either as 'the provincial bank' or as 'the BPD'. LPDs are non-bank financial institutions with a village development focus, owned by customary villages (*desa adat*). The *desa adat* is an indigenous community sharing common traditions and customs and unified by a common temple in Bali. [1] The highest authority of the *desa adat* is the assembly of its members. It elects a leadership board and agrees upon the *adat* (customary law to be applied within the village). The Board takes decisions based on the applicable customary law. An LPD is embedded in a community that is regulated and socially integrated by its *adat*. Conceptually, the customary laws can be a powerful framework of social integration and control, including loyalty of members to LPDs. The central bank classifies the LPDs as one of a broader class of non-bank rural financial institutions established by provincial governments from the 1970s and referred to as *Lembaga Dana dan Kredit Pedesaan*, or LDKP (literally 'rural fund and credit institutions').

The LPDs were established as part of a 'second generation' of LDKPs following a 1984 direction from the Ministry of Home Affairs for the more widespread replication of this model. According to Steinwand (2001), LPDs resemble most closely the *Badan Kredit Kecamatan* (BKK) of Central Java, although with several modifications. It is owned by the community (rather than the provincial government), is a village institution (rather than a sub-district one) and is a financial intermediary (rather than simply a credit institution). The ownership is in line with the objective to empower the customary villages. Holloh (1994) regards the LPDs as the most recent form of community financial institution in Indonesia, possessing unique characteristics. He explains:

> "*The unique character of the LPD lies in the fact that it is not related to the official village administration (desa dinas) but is an institutional element of the custom village (desa adat). The character of the desa adat as a democratic system regulated by*

customary law provides strong sociocultural bonds and effective control mechanisms. The LPD is not only the most recent but …also the most democratic form of local finance in Indonesia" (p. 4).

Initially, the provincial government of Bali established 161 LPDs during a three-year pilot phase between March 1985 and March 1988. Their number increased rapidly during the following years. Compared with LDKPs in other provinces, the LPD system in Bali has shown an outstanding performance. LPDs hold a major proportion (more than 80 per cent) of the overall assets of the LDKP systems in Indonesia (Holloh, 2001). The apparent success of the LPDs may be attributed to a number of factors, internal and external, and including institutional settings, management, products offered, the regulatory and policy environment. Of particular significance are the sociocultural and economic conditions of Bali, described briefly in Box 1.

***Box 1** The general condition of Bali Province*

Bali is one of the most famous tourist destinations in Asia with beautiful beaches and landscapes, a tropical climate and a unique and living Hindu culture. Tourism has developed rapidly in the province since the 1960s. One of the smallest provinces in Indonesia with an area of only 5,600 km^2 , Bali measures just 90 km along the north-south axis and less than 140 km from east to west. The population is dense with more than 500 persons per square kilometre, 3 million residents and 800 thousand households in 2003. The majority (more than 90 per cent) is Hindu, and there are thousands of Hindu temples in Bali, large and small.

According to the national socio-economic survey and the regional statistical bureau, Bali's economy was worth IDR 16.5 trillion (US$1.9 billion), or 1.3 per cent of the national economy in 2000. Per capita income was slightly above IDR 7 million (or about US$880) in 2003. However the regional economy has experienced little growth in recent years (1 per cent p.a. from 1997 to 2000 and 3 per cent from 2000 to 2003) and subsequent events have worsened the situation. Tourism plays an important role in the economy, in terms of incomes, employment and demand for local goods and services. In 2000, the trade, restaurant and hotel sector accounted 24 per cent of employment and 33 per cent of regional gross domestic product. However, the tourist economy is vulnerable to international security shocks. Recent terrorist attacks, such as the World Trade Center tragedy and the Bali bombings, impacted the economy negatively. Thus, the occupancy rate of hotel rooms in Bali plunged from 60 per cent to below 10 per cent after the first local bombing in 2003.

The institutions: the BPD and the LPDs

The provincial bank and the LPDs of Bali were initially established under the umbrella of provincial government regulations, as regional (local) enterprises. BPD Bali was established in 1965 and licensed as the regional development bank for Bali by the Ministry of Central Bank Affairs (predecessor of today's central bank) in the same year. Hence the provincial bank is supervised by the central bank under the banking act. The first LPDs were established in 1985 under provincial authority[2] but, unlike the BPD, they are not subject to central government regulation, being neither regulated banks nor credit cooperative institutions[3]. BPD's mandate is to accelerate economic development in the province of Bali, and the LPD system's task is closely linked to that, specifically, to empower the customary villages. An LPD serves its community by providing convenient access to financial services as well as an income source to cover the ceremonial and maintenance expenditures of the *desa adat's* temples.

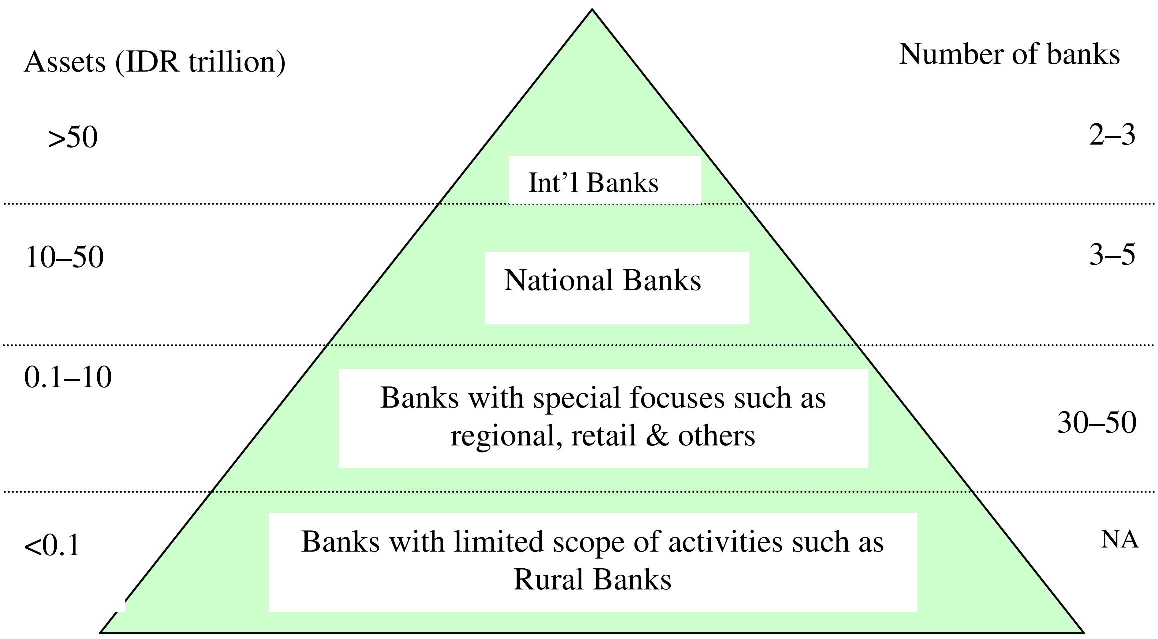
The provincial government and the customary village jointly provide the initial capital of an LPD. The initial capital provided by government was IDR 10 million (US$ 1,079) in

2002. A customary village is qualified for establishing an LPD when it has a written code of customary law and is judged to have sufficient economic potential. These qualifications must be confirmed by the district-level LPD Board. This is known by the acronym PLDPK, and comprises representatives from the government and BPD. The regulations have been amended several times. An important amendment increased LPDs' capital and upgraded their corporate status (from local government enterprise to limited company). Changes in regulation also addressed governance issues, such as establishment of LPD supervisory boards at village level and LPD centers at district level, the introduction of an insurance fund scheme, adoption of prudential banking principles, setting the maximum amounts an LPD can borrow, prohibiting equity investment and increasing minimum initial capital.

The architecture of the Indonesian banking system as envisioned by the central bank in the next 10 to 15 years (from 2004) is presented in Figure 1. The figure depicts the structure of the Indonesian banking system, consisting of four tiers, namely: international banks, national banks, banks with special focuses and banks with limited activities. Depending on their asset sizes, the commercial banks are distributed into one of the first three tiers while the 'rural' banks (BPRs, or *Bank Pembangunan Rakyat*) are members of the lowest (fourth) tier. BPD Bali is a small commercial bank with assets less than IDR 3 trillion (US$320,863,580) in December 2003. This makes it a third tier bank (Bank Indonesia, 2004). Since they are not banks, the LPDs do not feature in the diagram. For comparison, the average assets of an LPD are comparable in size to those of regulated banks in the fourth tier.

Although it is a small bank at national level, BPD Bali is a large bank in Bali, accounting for 15 per cent, 23 per cent, and 15 per cent of overall bank assets, loans and savings, respectively, in Bali in 2003. The overall bank assets, bank loans and bank savings in Bali in the year were IDR 17, 8, and 12 trillions, respectively. BPD has developed into a bank with a headquarters and 46 branch and sub-branch offices across the nine districts of Bali. These offices are generally located in areas surrounding the districts' cities.

Figure 1 *The envisioned structure of the Indonesian banking system*



Bali's LPD system has experienced even greater institutional development than the BPD since its inception. Their number increased rapidly, except during 1996–2001 because of national economic crisis and greater emphasis on consolidation. In 1990, the assets of the LPD system were IDR 375.3 billions while the assets of other LDKP systems ranged from IDR 0.8 billions for the LKP system in Nusa Tenggara Barat to IDR 67.9 billions for the BKK system in Central Java (Holloh, 2001). Recent statistics reflecting the institutional development of LPDs are given in Table 1, which shows that the number of LPDs substantially increased from 2001. Almost 1,300 LPDs were in operation in 2004, covering some 90 per cent of the customary villages in Bali. Thus, the objective ‘one LPD for each *desa adat*’ (as advised by the regulation) is nearly achievable as only a small proportion remains to be served. LPDs’ assets also significantly increased during the period. The governance of the LPD system is further discussed in the section below.

Table 1 *Institutional development of the Balinese LPD system, 1999–2004*

Year	Number of *desa adat*	Number of LPDs	Assets (IDR)
1999	1,364	912	336,679
2000	1,371	926	500,786
2001	1,380	953	695,435
2002	1,392	1,152	840,143
2003	1,407	1,208	1,071,645
2004	1,427	1,296	1,346,238

Source: BPD Bali, Denpasar

Governance of the institutions

Governance quality is generally assessed in terms of transparency, accountability, delegation of authority, participation of stakeholders and compliance with regulations. A lack of functional differentiation among the key stakeholders may result in conflicts of interest, ineffective management and services, weak supervision and weak enforcement, dysfunctional interference by local officials and fraud. Provincial regulations specify the governance structure of the LPDs, as noted above. The owners, the management, the supervision, the technical assistance providers, and their responsibilities and rights are specified in the regulations. The governance structure of the LPDs, as specified in the 2002 provincial regulation for LPDs, is summarized in Figure 2.

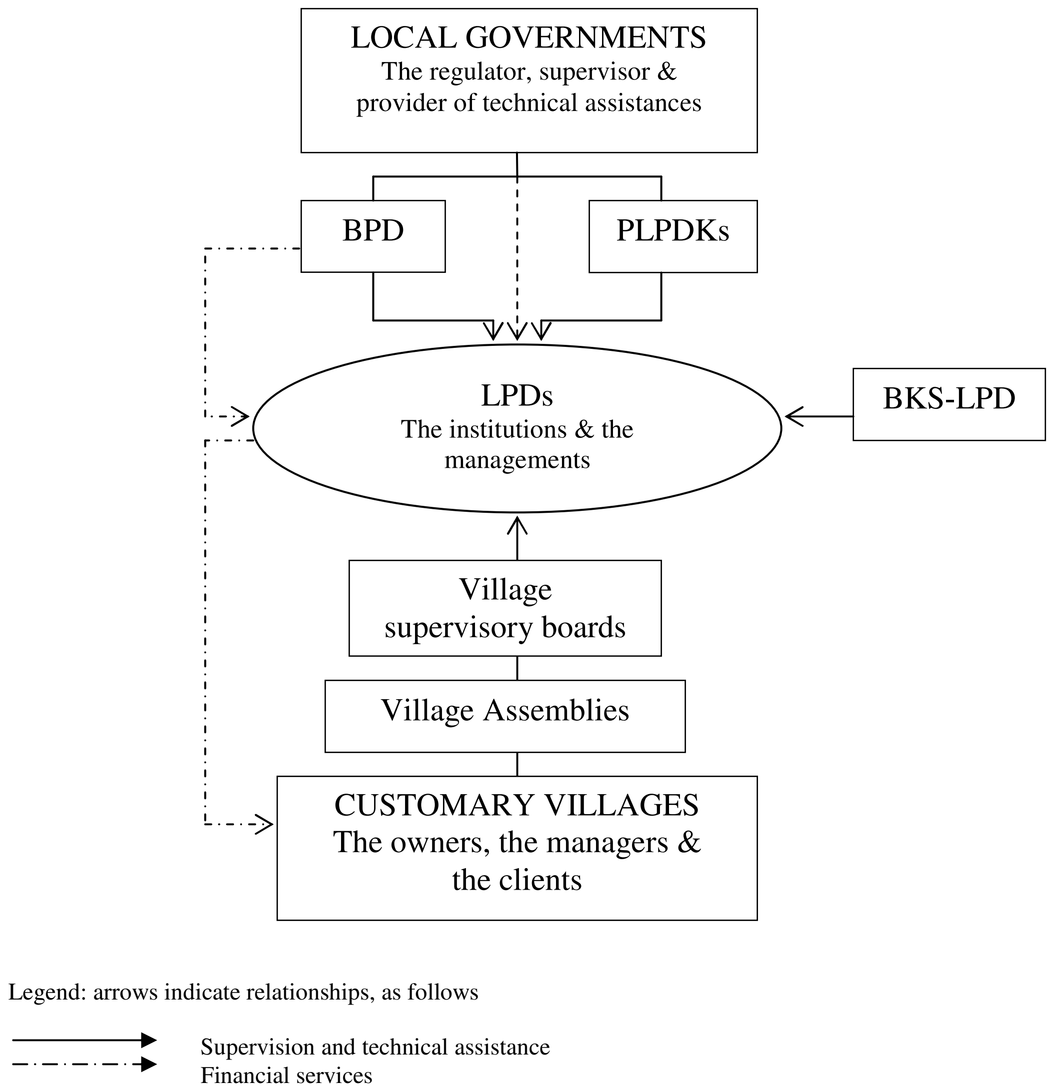


***Figure 2** The structure of the LPD system's governance, 2002*

Figure 2 depicts the governance of the LPD system. The provincial government delegates supervisory and technical assistance functions to the provincial bank along with PLPDKs. While BPD has carried out the function since the inception of the LPDs, the PLPDKs came to function with the 2002 regulation. The new regulation also suggests the establishment of an LPD association, BKS-LPD (*Badan Kerjasama* LPD). Except for the benefits of the management personnel, the regulation does not authorize BKS-LPD to play any function in the governance of the LPDs. How the supervisory and technical assistance functions are done is discussed later in the text. The village supervisory boards carry out daily supervision of their LPDs. The establishment of these boards is also advised by the new regulation, to give the villages an opportunity to effectively control the operations of their LPDs. As the management personnel, the village assemblies also choose the members of the boards from the village members. In other words, the villages (*desa adat*) function as the owners, managers, and village-level supervisors of the LPDs.

Thus, unlike the governance of parallel LDKP institutions in other provinces, which are fully or largely under the control of local governments, governance of the LPDs in Bali is apportioned between owners, regulators and operators. Elsewhere, community control is weak in the governance of village-based financial institutions, which although owned by communities are controlled by government officials (Holloh, 1994). Holloh claims that the effective control of the community in the governance of the LPD system is one of the determinants of the LPDs' success, relative to other village-based financial institutions in Indonesia.

However, the greater roles of the villages in the governance of the LPDs may create conflicts of interest. Our study found that there were cases of conflict of interest between management and village supervisory boards. Managements of several LPDs visited for this study considered the role of village supervisory boards too dominant in the selection of management personnel and in other decisions. Loan disbursement to clients, interbank loan applications, business plans and reports all require board approval. Boards frequently interfere with loan disbursement processes, threatening management independence, the effective implementation of prudential lending principles and the operational efficiency of LPDs, because of high non-repayment rates. Management often faces great difficulties when new board members are appointed. New board members may have incomplete knowledge about matters of LPD management. For instance, a newly constituted Board can demand that the manager of a well-performing LPD be replaced. Such a replacement may be costly, harming the future of the LPD because the new manager may lack the necessary skills and experience.

With assistance from GTZ, the provincial government has attempted to set a standard qualification for suitable persons as managers of LPD-type institutions and has developed a training program to certify them. However, individual villages may lack qualified persons ready and willing to take the position as LPD manager. Persons with banking management skills and experience are generally rare in the villages, and those with the required skills and experience are not likely to take the position since the wages are very low. Therefore, replacement of a good LPD management should be prevented since failure cases of LPDs have resulted primarily from mismanagement, according to the supervisors from BPD and PLPDKs (informal interviews). The same was also reported for the reasons of recent failures of several LPDs in Negara District (Openg, 2004).

Furthermore, recent policies of national decentralization giving greater authority to district governments may bring other problems. District governments in Bali may attempt to get greater control over the LPDs in their jurisdictions. For instance, the district of Denpasar City introduced its own regulation concerning the LPDs in its region, authorizing the district government as the principal regulator, the supervisor and the technical assistance provider of the LPDs. These authorities properly belong to the provincial government, under the provincial regulation (discussed above). A more important deviation is that the LPD association (BKS-LPD) assumes the supervisory and technical assistance functions delegated to the provincial bank and PLPDKs, under the provincial regulation. Thus, conflict can arise between the provincial government and district governments concerning their role with respect to LPDs. Such conflict may weaken the governance of LPDs and threaten their future performance.

Figure 3 also depicts the LPDs' financial services to clients and their financial linkage with the BPD. The services of the LPDs are discussed further in the next section. Their financial linkage with the provincial bank includes saving and credit links. While it is compulsory for the LPDs to place their excess funds with BPD, it is optional for the LPDs to borrow from it. Instead, LPDs may choose to take loans from other financial and non-financial institutions. However, savings and credit links between the LPDs and the provincial bank are totally commercial and prudential. The 2002 provincial regulation requires LPDs to implement prudential banking principles. BPD is not responsible for bailing out failed LPDs, nor is it the lender of the last resort. In case of LPD failures, the government generally serves as the lender of the last resort. In this regard, an insurance mechanism was established to cover the bailout costs in case of an LPD failure.

The services and performance of the linked institutions

As a commercial bank (a *Bank Umum*), BPD can offer a wide range of financial services, from saving, credit, transfer/payment services to foreign exchange services, excluding insurance and pawnshop services to the general population (under the 1992 Banking Laws and as amended in 1998). However, saving and loan services are the core and form the major income sources of the BPD. The provincial bank's services are provided in branch offices, often far from clients' homes and businesses, especially those in remote rural areas. This 'in office' service strategy, on the one hand, and the fact that BPD's offices cluster around the cities, on the other, limit the rural outreach of its services. Links with the LPDs could perhaps help the BPD to overcome this rural service problem. In this regard, the provincial bank has two relevant (micro) loan service products, known as PUNDI and KPKM. The former targets the business enterprises of the poor while the latter aims at the promotion of small and medium enterprises.

Under PUNDI and KPKM, loan transactions between BPD and LPDs are commercial. BPD charges a commercial interest rate and treats an LPD as proxy for a group of the targeted clients, for which the LPDs assume full responsibility as the borrower. The LPD, in turn, re-lends the funds to its clients, applying its own credit policies. Hence, the PUNDI and KPKM loans are sources of additional loanable funds for LPDs facing high growth of loan demand. In fact, however, only a few of the LPDs are liquidity-constrained. Most LPDs have excess liquidity and place funds with the BPD. The extent to which the linkage between BPD and LPDs has improved rural access to financial services is a subject discussed in following section.

As village non-bank financial institutions, LPDs only provide saving services and loan services to their customary village members. Saving products offered include passbook and term deposits. Loan products vary from one LPD to another and no standardization has been suggested by the supervisory board. But while there is scope for a variety of experiments in product development as between LPDs, there is no scope for competition between them. This is because clients have limited freedom to switch their custom from one LPD to another, given their allegiance to a particular *desa adat.* However, there is strong competition between any LPD and other financial institutions within its area of operation. For instance, there were 10 rural cooperatives and rural banks in the *desa adat* of one of the LPDs visited in this study.

Voluntary saving deposit accounts are the primary sources of funds mobilized by the majority of the LPDs, while compulsory savings generally contribute less than 10 per cent of funds mobilized. At present, LPDs offer 9–10 per cent annual effective interest rates on passbook savings, and 9–16 per cent on term deposits, rates close to those of commercial banks. In determining interest rates, most LPDs react flexibly to local market conditions and their own need for funds.

Generally, an LPD offers a monthly credit (with 6 and 12-month terms) and a local specific loan product. An LPD with farmers as the core clients offers loans with seasonal terms, while an LPD with small industries and traders as the core clients has loans with daily or weekly terms. The sizes of loans and savings also vary, but the modes are less than IDR 5 million (US$627.75 in 2003). Interest rates of service products also vary, depending on the interest rates of comparable services offered by other financial institutions in the rural financial market, such as cooperatives and rural banks. Consumption loans are of some importance in larger LPDs. The present interest rates charged on monthly loans range from 2 per cent declining to 3 per cent flat per month. Seasonal loans (6 months) carry similar interest rates. Loans with daily installments have most usually a 100-day term, with annual effective annual interest rates ranging from 36 to 72 per cent. LPDs emphasize service convenience by servicing at the client home or workplace, requiring minimum paperwork and collateral, and offering quick loan appraisal, generally 3 days or less. Data reflecting the loan and saving performance of the institutions are given in Tables 2 and 3.

Table 2 *Loan and saving portfolios of BPD Bali, 2000–2003*

Year	Loans outstanding		Saving deposits	
	BPD Bali (IDR million)	As percent of all banks in Bali	BPD Bali (IDR million)	As percent of all banks in Bali
2000	63,1585	15.82	1,177,852	10.78
2001	1,012,427	16.67	1,715,191	13.39
2002	1,440,695	20.34	1,776,537	16.32
2003	1,845,852	22.69	1,826,212	15.33

Source: BPD Bali (2000; 2001; 2003)

Table 2 shows that BPD performed relatively well during 2000–2003, mobilizing substantial proportions (11–16 per cent) of overall bank savings in Bali and from 16 to 23 per cent of overall bank loans. Furthermore, the share of BPD in the overall bank savings and loans steadily increased. The relatively high saving and loan shares of the provincial bank, along with its financial sustainability (discussed latter) suggest that it is an effective supplier of financial intermediation services. Perhaps befitting its role as the provincial development bank, it was more successful than the banking system as a whole in relending funds within the provincial economy. To some extent, the BPD's links with the LPD system may contribute to the good savings performance of the bank (a topic discussed further later).

The LPD system also performed impressively with respect to volumes of loans and savings outstanding over the period 1999–2004 (Table 3).

Table 3 *Lending and saving performance of the LPD system, 1999–2004*

Year	Loan		Passbook saving		Term deposit	
	Amount (IDR million)	Borrowers (number)	Amount (IDR million)	Savers (number)	Amount (IDR million)	Savers (number)
1999	215,774	204,842	143,929	573,751	112,157	37,780
2000	355,092	218,632	227,820	626,576	164,873	50,204
2001	512,085	233,990	307,906	702,581	232,623	41,055
2002	638,206	270,321	346,676	781,759	283,529	44,880
2003	759,182	301,328	429,056	836,005	385,360	49,320
2004*)	907,312	318,995	559,746	956,633	487,538	55,375

Source: BPD Bali (2003)
Notes: *) Condition in September 2004.

Table 3 shows that loans advanced and the passbook and term deposits mobilized increased more than 70 per cent during the period. Similarly, the numbers of borrowers and savers also increased more than 30 per cent. Compared with the overall LDKP system in Indonesia, the LPD system was dominant, accounting for more than 70 per cent of savers, 75 per cent of saving deposit amounts, 41 per cent of borrowers and 64 per cent of loan amounts in 2000.

It is striking that the 1997 national economic crisis did not affect the savings and credit performance of the LPDs negatively. Rather, a substantial increase was also observed during 1996–1998 (the period in which the economy experienced the banking crisis). Total value of loans outstanding increased 52 percent, from IDR 95,519 million in 1996 to IDR

145,541 million in 1998; while the amounts of saving deposits increased 64 percent, from IDR 94,007 million to IDR 154,346 million.

Thus, the crisis did not bring a significant negative effect to the overall LPDs' operations as the national crisis did not bring the tourism industries down. As noted above, Bali's economy is largely dependent on tourism. Contrarily, more recent bombings on the island negatively affected the local economy. Even so, the tourism industries' downturn might not significantly affect the performance of the LPDs since the business activities of their clients are generally not related to the tourism industries. The performance of individual LPDs is also influenced by internal factors. LPDs with larger assets, more developed service products and experienced management may perform better than LPDs with smaller assets, less developed service products and inexperienced management.

Financial sustainability of the institutions

BPD and the LPDs are financially sustainable institutions as their operations are profitable. Table 4 shows selected financial ratios. The returns on asset and equity (ROA and ROE) during 2000–2003 were consistently higher than the central bank standards for 'healthy' regulated financial institutions. The central bank standards require a healthy bank to have ROA at least 1.125 per cent per annum and ROE at least 15 per cent per annum. LPDs typically maintained high loan to deposit ratios (LDR), at 90 per cent or above. The LPDs loan repayment rates were high, with 'non-collectible' loan rates much less than 5 per cent. Non-collectible loans here refer to the amounts of loan principal and interest declared uncollectible by the institutions.

The high achievement of the LPD system reflects the trust and support of the village communities besides the service and management quality. The importance of the community trust and support is obvious, considering the facts that several other financial institutions also operate in the rural financial market, such as Rural Banks and Cooperatives. The service and management quality are closely linked with the quality of supervision and technical assistance. In this regard, the role of BPD and the government (including village government) is crucial. Also, 'ownership' is among the major factors explaining the community's trust in and support for the LPDs.

Table 4 *The selected financial ratios of BPD Bali and the LPD system, 2000–2003*

Year	ROA	ROE	LDR	NCL
BPD				
2000	1.86	25.98	47.19	0.09
2001	3.44	46.04	55.16	0.02
2002	4.16	35.83	81.53	0.10
2003	4.37	29.61	83.21	0.33
LPD				
2000	7.31	56.37	90.00	1.69
2001	7.83	61.22	95.00	1.23
2002	7.96	52.75	101.00	1.13
2003	6.63	41.95	93.00	1.34

Source: BPD Bali (2000; 2001; 2002; 2003)

Notes: NCL is the non collectible loan rate, the amounts of loans (principal plus interest) that had been in arrears and declared uncollectible by the institutions.

Moreover, people may also feel obliged to save their funds with their LPDs and to borrow loans from them in order to promote the development of their own enterprises (LPDs) whose benefits are for the communities. The benefits include the retained profits, and the development funds of the customary villages. The regulation states that LPDs allocate 40–60 per cent of their profits for capital formation, 20 per cent for village development funds, and 5 per cent for social funds. The development funds are used by the village for financing the maintenance and ceremonial expenses of the customary village temples.

The socio-economic and demographic environment also plays a great role in the LPDs' apparent success. Bali has socio-economic-demographic and cultural characteristics (such as dense population, prosperous economy, and supportive social and cultural system) which are regarded as key determinants of successful rural banking. Moreover, customary villages in Bali have the power to demand and enforce their members' loyalty to LPDs, in terms of saving their funds and repaying their loans. The maintenance and ceremonial costs paid with the LPDs' profits give an economic incentive to the members to stay loyal to the LPDs, as described above. Unlike the parallel institutions in other provinces whose management personnel may be appointed by provincial government, LPDs are managed by member representatives chosen by the villages themselves. This democratic management further strengthens the loyalty of the members to LPDs. However, as noted above, individual LPDs may perform differently.

Since many of the LPDs have been operating for more than two decades and are performing well, the management of certain LPDs may have found that they needed to extend their service areas beyond the village where they belong to, to achieve higher operational scale and operational efficiency. Apart from limiting the LPD's growth, the service area limitation makes it vulnerable against risks resulting from local casualties (such as natural disaster and harvest failures), which make the clients unable to meet their obligations to the LPD. The intention, however, is prevented by the regulation. It states that an LPD is to serve only the members of the customary village where it is located or belongs. As against this, the operational area limitation of individual LPDs can be regarded as one of the determining factors for the success of the LPDs. It ensures close identification with and support of *desa adat* and the members (noted above). Therefore, successful LPDs are trapped by the dilemma that the very thing that assures their success is also a barrier to their expansion beyond the boundaries of the *desa adat*, and hence a barrier to their achievement of economies of scale.

The linkage

The links between the provincial bank and the LPDs are in existence since the inception of the LPDs and institutionalized with provincial government regulations. Under the 1988 regulation, the provincial Governor has responsibility to supervise the LPDs (although in practice this is delegated to the BPD). BPD also provides technical assistance. BPD assigns two (full-time) officers in the headquarters and branch-based officers to carry out the supervisory and technical assistance responsibilities. The responsibilities include report review, field visit, collating data for the LPD system and training of LPD management. As the number of LPDs has greatly increased, the new (2002) regulation introduces the establishment of district centres for LPDs (the PLPDKs) to support BPD in carrying out its responsibilities effectively. In future, these centres will assume the supervisory and technical assistance responsibilities at district level.

For the supervision purpose, individual LPDs have to submit their annual business plan (3 months prior to the implementation) and three periodic reports (monthly, three-monthly and annual) to BPD. The reports are also submitted to the village assembly and the (provincial/district) government through the PLPDKs. In addition to reviewing the reports, on-site supervisions in LPD offices are also conducted. For the technical assistance purpose, BPD (along with PLPDKs) is responsible for the management training of the LPDs. At least one training is organized per year. Under the 1988 regulation, 5 per cent of the profit covers the supervisory and technical assistance services. Under the 2002 regulation, a part of these supervisory and technical funds is saved for the insurance funds of LPDs. The LPDs submit the funds to BPD, which then distributes them to PLPDKs (50 per cent), district and provincial supervisory boards (32.5 per cent), LPD insurance funds (7.5 per cent), and as well as retaining 10 per cent itself. As a percentage of the LPDs' profits the distribution of the supervisory and technical funds are: 2.5 per cent, 1.63 per cent, 0.38 per cent, 0.38 per cent and 0.5 per cent to PLPDKs, district and provincial supervisory boards, LPD insurance funds and BPD, respectively.

Holloh (2003) identified four kinds of linkage between superordinate and sub-ordinate institutions. These are saving linkages, credit linkages, facilitation linkages, and capacity building and supervision linkages. The saving linkage occurs when the subordinate institution is assisted in managing excess liquidity by holding an account with the superordinate institution. The credit linkage occurs when the subordinate institution faces effective demand for credits exceeding its loanable funds, and/or when the subordinate institution channels loans from the superordinate institution to the clients. The facilitation linkage occurs when the subordinate institution facilitates the access of the superordinate institution to clients within its operational areas. For instance, as the subordinate institution does not offer a demand deposit or large-sized loan services, it facilities the clients to get the services from the superordinate institution. Lastly, the capacity building and supervision linkage occurs when banks take on capacity building and/or supervision functions for the benefit of the subordinate. The supervision and technical assistance links between the provincial bank and the LPDs can be regarded as a 'capacity building and supervision' linkage.

Regulations also require each LPD to place its excess liquidity with the nearby branch offices of BPD. This is a 'saving linkage'. As to credit linkages, the regulation does not prohibit LPDs from taking loans from institutions other than BPD. In principle this enables LPDs to get loanable funds from various sources with lowest costs possible, including from donors and government-subsidized credit schemes. However, LPDs when in need of loans often consider taking loans from the provincial bank if more convenient, especially considering their access to a concessional interest rate, discussed further below. With their current institutional status, operating under the provincial government regulation without any operational status recognized in the national legal framework, such as a saving and credit cooperative or a rural bank, LPDs have less chances to receive loans or finances from a national bank or financial company, in case they need external funds. Although external funds are not an issue of most LPDs, considering the fact that the majority of them are in excess of funds, leaving the options open wide may be helpful for future development of the LPD system.

The institutional status of LPDs has been an unresolved issue since introduction of a 1988 national policy package for the banking sector. The failure of national authorities to resolve this problem, despite the passing of various deadlines for the LPDs (as for all LDKPs) to regularize their status, may suggest that there are resistances at provincial and local level to the national policy thrust. Governments argue the negative consequences for the future of the LPD system resulting from the new status, either as a rural bank or rural cooperative. This is because the national regulations have several elements contradictive of the provincial regulation, in terms of operational areas, supervision and tax policy, among others.

Individual LPDs can put excess funds with the provincial bank immediately after their establishment, but they have to show good performance for two consecutive years to be eligible for loans from BPD (BPD Director Decree No 0246.101.10.2003). Such loans are for additional loanable funds to 'well performing' LPDs, not bailout loans. Under the 1988 regulation, the provincial/district government is responsible for bailing out a poorly performing LPD. The government is no longer responsible for bailing out problem LPDs since the introduction of the new (2002) regulation, which authorizes the establishment of an LPD insurance scheme (noted above). In practice, however, the supervisory boards encourage the management of the LPD and the respective village to solve the problem, before deciding to bail out a poorly performing LPD. In their attempts to solve liquidity problems resulting from poor management, frauds, or others, individual LPDs may make the management (including their relatives) responsible for frauds and misbehaviors. The case of the failure of *Kapal* LPD in 2000, where management was made responsible for the bailing out, illustrates this point (informal interview with the head of the village assembly). If there were no management frauds or misbehaviors, the village boards would ask the (wealthy) members of the villages to deposit more funds. If the managements and the village boards could not solve the problems themselves, they would request government's assistances. The government decision would depend on the recommendation of BPD and PLPDKs. Normally, only the feasible ones are bailed out.

In response to the regulations and to promote the development of the LPDs, the provincial bank applies a special interest rate policy to the LPDs. The policy specifies that in dealings with LPDs, the provincial bank pays a higher interest rate on savings and charges a lower interest rate on credits than is applicable to the regular clients. BPD applies 6.5 per cent interest on savings and 14 per cent interest on loans in transactions with LPDs while applying 4–5 per cent and 14–18 per cent for comparable saving and loan services to the general clients, respectively. The special interest rate policy should give an incentive to an LPD to save its excess funds with and borrow from the provincial bank, rather than deal with other institutions. With a few exceptions, LPDs generally do so, and the extent of these links is discussed later. The special interest rate, however, is still within the range of commercial rates specified by the central bank for prudential purposes. Outside that rate range, bank savings are not eligible for the central bank's saving guarantee, and bank loans are qualified as risky. This is not an interest rate cap, but a measure to prevent the banking system from incurring problems arising from 'moral hazard' behavior of bankers.

In summary, the linkage is essentially a simple (quasi-commercial) bilateral linkage, in operation since the inception of LPDs in 1985 and built into the design of the LPD system. The main driver is the government of Bali, which promotes the establishment of an LPD, provides the initial funds, and designs and introduced the provincial regulation and provincial government decrees that govern the linkage.

The extent of the supervisory and technical assistance linkage

In this linkage, the provincial bank provides supervision and technical assistance to the LPDs. The tasks include training of the management of LPDs, reviewing of their business plans and reports (noted above), field visits (for on-site supervision and technical assistance), and collating data of the LPD system (at provincial level). Training modules include skills to manage an LPD: LPD regulation, business planning, service product design, saving and loan management, financial management, bookkeeping and reporting, and risk management. BPD (and PLPDKs) organize the training once a year, at least. Individual LPDs submit the reports to the district branch offices of BPD. After reviewing them, the branch offices consolidate the reports and submit them to the headquarters office. During the review process, the officers of BPD may give advice and suggestions to LPD management, and if necessary, the officers visit LPD offices.

Considering the relatively high service performance of LPDs (discussed above) and the familiarity of the the provincial bank officers with LPD management (noticed by this study in the field), the supervisory and technical assistance seem to be successful. Each LPD pays the costs of the supervisory and technical services with 5 per cent of its profits, referred to as the supervisory and technical assistance funds (noted above). The new (2002) regulation rules that 7.5 per cent of the funds are allocated for the LPD insurance funds. Therefore, the amounts of the funds would be dependent on the profitability of the LPDs. During the period of 1999–2003, the amounts of the supervisory and technical assistance funds were relatively large (Table 5) as the LPD system generated relatively large profits, comparable to 41 to 66 per cent of the BPD profits during the period. Table 6.5 indicates that the supervisory and technical assistance funds were 3 per cent of the overall LPD operational costs, up to 1 per cent of BPD's operational costs, and 2–5 per cent of BPD's labour costs, during 1999–2004. In addition, the amounts of the LPD supervisory and technical assistance funds steadily increased as the profits of the LPDs grew. The saving and credit linkage is discussed below.

Table 5 *LPD supervisory and technical assistance funds, 1999–2004*

Year	IDR million	As a % of LPD operational costs	As a % of BPD operational costs	As a % of BPD labour costs
1999	1,355	2.98	0.43	2.31
2000	1,831	2.84	0.86	3.29
2001	2,719	2.88	0.91	3.89
2002	3,344	2.76	0.78	4.58
2003	3,552	2.56	0.99	4.39

Source: Calculated based on Data Provided by BPD Bali

The extent of the saving and credit linkage

The saving and credit linkage between BPD and the LPDs is reflected by the interbank savings and interbank loans of the LPDs because of several reasons. First, by regulation (noted above), an LPD has to put its excess funds in BPD. Second, BPD treats individual LPDs as its special clients with a higher interest rate on savings and a lower interest rate on credits, relative to the general clients (noted above). The transaction processes are quick and convenient. Third, the LPD / BPD relationship has lasted since the inception of the LPDs, where the provincial bank serves as the supervisor and technical assistance provider to the LPDs (as noted above). The LPDs regard BPD as their father, in their words: *'BPD bapene LPD'*. Therefore, they are generally loyal to BPD with respect to bank saving and credit services. The inter bank savings and credits of LPD are reflected in Table 6.

Table 6 *Interbank savings and loans of the LPD system, 2000–2004*

Year	Interbank savings		Interbank loans	
	IDR million	As % of assets	IDR million	As % of assets
2000	94,578	19	717	0.14
2001	114,133	16	2,194	0.32
2002	132,938	16	3,111	0.37
2003	216,343	20	3,531	0.33
2004	375,396	28	3,067	0.23

Source: Calculated from data provided by BPD Bali

Table 6 shows that the amounts of savings LPDs placed with banks and the amounts of borrowings from BPD increased between 2000 and 2004. The savings placed by LPDs with BPD were quite substantial, much larger than the amounts of credits borrowed. LPDs' interbank savings was comparable to 16 to 28 per cent of the LPD system's assets, or 7 to 12 per cent of the amount of saving deposits mobilized by BPD during the same period. On the other hand, credit obtained by LPDs from banks was relatively small, far less than 1 per cent of the amount of BPD's loan outstandings.

Thus, the LPDs are net savers in the saving and credit linkages with BPD. The saving-credit discrepancy in the linkage mirrors the financial intermediation performance of the LPDs, which generally mobilize more savings than disbursed loans. This is a common feature among well-performing rural- and micro-finance institutions, such as BRI Units and others well known in the literature. The saving-credit discrepancies may result from limited investment opportunity and risk-averse investment behavior of the clients, among others. Balinese communities generally see saving as the capital formation strategy and consider borrowing as the last resort. Hence, the linkage has opened the opportunity for the LPDs (and the villages) to earn income from their otherwise unproductive funds through the interbank markets. This improves the efficiency of the economy, in aggregate terms, apart from the benefits to the individuals and institutions concerned. Also, and importantly, the saving and credit linkages have provided a relatively large and reliable source of funds for the provincial bank while giving an effective and convenient liquidity management system to the LPDs. Individual LPDs can cost-effectively and conveniently save their excess funds with BPD or borrow from BPD should they need additional loanable funds.

However, a word of caution is necessary concerning the future of the saving and credit linkage. Opposition to these compulsory arrangements has begun to appear in news-media since 2000 (e.g., Antara, 2000). Many LPDs consider the restriction unfair, eliminating their opportunities for higher interest income. This may endanger the future of the financial linkage. One of the LPDs visited put a part of its excess funds into a cooperative set up by the LPD association (BKS-LPDs) as it offered higher interest rates and allowed withdrawals on Saturday, when the BPD was closed. The consequences of the linkages to BPD and the LPDs (including the villages, as the owners and the clients) are discussed next.

Some assertions about the impacts of BPD-LPD linkages

This section briefly discusses the financial impacts of the linkage on the institutions, the LPDs and the provincial bank. Impacts on the customary village communities (as the owners and the clients of the LPDs) are also discussed. Results reported here are based on unpublished research by the writer and for reasons of space it is not possible to spell out the arguments or the data in detail. Conceptually, the LPDs and BPD should benefit from the linkage, as should the communities within which they operate. However, the costs and benefits were difficult to quantify accurately. In spite of the difficulties, the impacts of the linkage to the institutions and the communities were estimated, making use of data available (primarily from BPD) and the best judgments of the researcher. As the linkage started at the inception of the LPD system, impacts were assessed from 1985 to 2002. Costs were partitioned between three categories: establishment costs, supervisory and technical assistance, financial service costs and other institutional development costs. Measured benefits included the retained profits of LPDs, profits earned by BPD through access to the excess funds of the LPD system and the financial benefits received by communities from LPD profits. Estimation of the value to communities of having access to effective and convenient financial services was also attempted, using assumptions about the opportunity cost of funds placed with LPDs by communities and the costs of alternative sources of credit for village borrowers in the absence of the LPDs.

In terms of overall cumulative costs and benefits, the linkage reached its breakeven point in 1992 (year 8) if the net benefits of community access to LPD services are taken into account, or in 1999 (year 15) if they are not. This was in spite of the rapid and continued growth of the LPD system over the whole period, involving substantial establishment costs in each year. With net benefits of community access included, the benefit/cost ratio was 3.46 to 1 by 2003, and without them it was 1.42 to 1. In terms of costs and benefits applicable to particular categories of stakeholder, the linkage provided services to more than 7 million savers and more than 2 million borrowers. The value of this service access was calculated at IDR 435 billion. The linkage brought about IDR 197 billion retained profits to LPDs while giving IDR 23 billion profits to BPD over the period of 1985–2003. Lastly, the linkage also contributed more than IDR 82 billion to the villages' development and social funds in the same period. The provincial government's intention was to empower the customary villages in Bali through the development of the LPD system, and it succeeded in that the linkage benefited the parties involved and the benefits generated exceeded the costs.

Summary and conclusions

The linkage between the provincial bank and LPDs can be regarded as a simple bilateral linkage involving supervisory and technical assistance, and savings and credit services. BPD provides the supervisory and technical assistance necessary for the LPDs. They save excess funds with BPD and may borrow from the provincial bank. The links are generally commercial in that the LPDs pay commercial rates for services. The linkage was initiated by the provincial government of Bali to empower the customary villages, beginning in 1985. The government provides initial capital and the training of new LPD managements. The villages also contribute to the initial capital. In addition to provision of financial services to the communities, the establishment of the LPDs is also to generate incomes for the villages to cover the maintenance and ceremonial expenditures of their common temples. These social benefits, in turn, contribute to the social cohesion of the communities concerned and motivate them to behave supportively and loyally to their LPDs.

The linkage has performed relatively well in terms of the performances of the institutions involved. Both institutions are financially healthy. The number of LPDs and their assets, savings, credits and clients significantly increased during 1999–2004. The amounts of the LPDs' savings with BPD and the amounts of credits borrowed from BPD also increased during the period. An increasing trend in the performance indicators of the institutions was also found earlier, including during 1996-1998, the period of national economic crisis. Recent bombings (remembering that tourism is the major sector in the economy) only affected the economies of villages around the handcraft centers. Detailed estimates of the financial impacts of the linkage from 1985 to 2003 further confirmed that the linkage brought more benefits than costs to the parties involved, namely government, village communities, the LPDs and BPD.

The apparent success of these linkages is the result of several factors, including the institutional settings, the government's strong commitment and support, and village communities' positive participation and loyalty. In addition, credit must be given for the dedication, hard work, and accountability of managements, the provincial bank's helpful supervision and technical assistance and financial services, and the supportive socio-economic and demographic conditions. These are factors internal to the institutions concerned, as well as external (or market environment) factors. These findings reflect the performance of the linkage between the LPDs (as a system) and BPD. Conceptually, the performance of the linkage between individual LPDs and BPD might vary from one another as their internal and external factors are not identical. For example, individual LPDs with larger assets, more developed service products, and experienced management tend to perform better than LPDs with smaller assets, less developed service products and inexperienced management. In fact, however, the study found that cases of non-performing LPDs were rare.

For those few ‘failure cases’, misbehavior of management personnel and village board members and a poor economic environment locally were among the primary causes.

In spite of the apparent success of these linkage arrangements, there are five issues considered important for further improvement. First, the growing opposition of individual LPDs to the restriction on interbank saving accounts, which requires LPDs to place their excess funds with BPD, may endanger the future of the financial service linkage. This is because many LPDs may decline to place their excess with BPD, and put them with other financial institutions best serving individual LPDs’ needs. Second, ‘successful’ LPDs may face a dilemma that the very thing that assures their success is also a barrier to their business expansion beyond the boundaries of the *desa adat*, and hence a barrier to their achievement of higher operational scale and efficiencies. However, among the organization settings and governance structure of the LPDs often regarded as the determinants of the LPDs’ relative success are that they are owned and managed by the *desa adat,* for the benefit of the members, and to serve the members only.

Third, related to the issue above, the LPDs have fewer chances to receive loans or finances from a national bank or financial company, in case they need external funds. This is the result of their current institutional status, operating under the provincial government regulation without any status recognized in the national legal framework, such as a saving and credit cooperative or a rural bank. Although external funds are not an issue for many individual LPDs, it is for a few that face loan demands higher than their funding capacities. More importantly, leaving the option of getting external funds open may be helpful for future development of the LPD system. Fourth is the current governance structure of individual LPDs which gives a dominant role to the village board in the selection of the LPD’s manager. This may lead to misbehavior of the board members and could potentially threaten the future performance of the LPDs.

Lastly, the greater power of district governments authorized by the (1992) national decentralization policy has resulted in a conflict of interest between the provincial government and district governments concerning their regulatory power over the LPDs. For example, the district of Denpasar City introduced its own regulation concerning the LPDs in its administrative jurisdiction, containing elements contradictive of the provincial one. Such governance restructuring may be counterproductive to the future performance of the LPDs.

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[1] The *Desa Adat* is not co-extensive with the *Desa Dinas*, the lowest unit of official administration in Indonesia. A *Desa Dinas* is generally larger than a *Desa Adat*.
[2] Governor's Decree (No. 972/1984) confirmed by Provincial Government Regulation (No. 2/1988).
[3] They are not subject to either the national Banking Laws (No.7 /1992 and No. 10/1998) or the Savings Cooperative Regulation (No.9/1995).