MICROFINANCE INNOVATION CENTER FOR RESOURCES AND ALTERNATIVES

FINAL

Micro Credit Strategy Formulation Mission

for the National Community Empowerment Program
or
Program Nasional Pemberdayaan Masyarakat (PNPM)

Presented to the Government of Indonesia, the World Bank and the Decentralization Support Facility (DSF)

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ABOUT MICRA

The Microfinance Innovation Center for Resources and Alternatives (MICRA) is an Indonesian foundation focused solely on the development of the microfinance industry. MICRA was founded in early 2006 by Mercy Corps, in order to institutionalize and expand its work over the past six years in microfinance throughout Indonesia. Its mission is to build the institutional strength and outreach of the Indonesian microfinance sector, by providing a full range of high-quality, best-practice technical inputs and support to all industry stakeholders in a sustainable and demand-driven manner. As an independent support center, MICRA is committed to promoting innovations, transparency, increased outreach to the poor and ever-improving performance in the microfinance industry.

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TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

LIST OF APPENDIXES

Appendix 9	Characteristic of UPP Beneficiaries
Appendix 10.	Summary of Micro-Credit Project Features
Appendix 11.	Supplemental Detail on KDP Project Performance
Appendix 12.	Supplemental Detail on KDP Project Performance

LIST OF ABBREVIATIONS AND ACRONYMS

ADB	*Bank Pembangunan Asia*	Asian Development Bank
APBN	*Anggaran Pendapatan dan Belanja Negara*	National Budget
Bappeda	*Badan Pembangunan Daerah*	Area Development Agency
BAPPUK	*Berita Acara Penetapan Prioritas Usulan Kegiatan*	Minutes of Priority Setting on Activity Proposals
BI	*Bank Indonesia*	Bank of Indonesia
BKAD	*Badan Kerjasama Antar Desa*	Inter-Village Coordination Body
BKD	*Badan Kredit Desa*	Village Credit Committee
BKM	*Badan Keswadayaan Masyarakat*	Commmunity Empowerment Body
BLM	*Bantuan Langsung Masyarakat*	Direct Assistance for Communities (commonly known as 'block grants'-*sic!)*
BMT	*Baitul Maal wa Tamwil*	Islamic Financial Institution (that manages zakat)
BPD	*Bank Pembangunan Daerah*	Provincial Development Bank
BPR	*Badan Perkreditan Rakyat*	Rural Bank
BPRS	*Badan Perkreditan Rakyat Syariah*	Islamic Rural Banking
BPS	*Biro Pusat Statistik*	State Statistics Bureau
BPUPK	*Badan Pengawas Unit Pengelola Kegiatan*	Supervisory Board on Activity Management Unit
BQ	*Baitul Qiradh*	Islamic Investment & Finance Cooperative
BRI	*Bank Rakyat Indonesia*	(name of a commercial bank)
BUMDes	*Badan Usaha Milik Desa*	Village-owned Enterprise
BNI	*Bank Negara Indonesia*	(name of a commercial bank)
CDA	Cluster Development Association	
CDF	Community Development Foundation	*Yayasan Pengembangan Masyarakat*
CMLF	Community-Managed Loan Funds	*Dana Pinjaman Swa-kelola Masyarakat*
CRS	Catholic Relief Services	*Pelayanan Bantuan Katolik*
ETF	Employment and Training Foundation	*Yayasan Penempatan & Pelatihan Tenaga Kerja*
FGD	Focus Group Discussions	*Diskusi Kelompok Terarah*
FK	*Fasilitator Kecamatan*	Kecamatan/Sub-district Facilitator
FSS	Financial Self Sufficiency	*Swa-sembada Keuangan*
GoI	*Pemerintah Indonesia*	Government of Indonesia
IFC PENSA	International Finance Cooperation Program for Eastern Indonesia SME Assistance	*Program Kerjasama Keuangan Internasional untuk membantu Usaha Kecil & Menengah di Indonesia Timur*
KDP	Kecamatan Development Program	*Program Pengembangan Kecamatan*
KMW	*Konsultan Manajemen Wilayah*	Area Management Consultant
KSM	*Kelompok Swadaya Masyarakat*	Community Self Helf Group
Korkot	*Koordinator Perkotaan*	Coordinator at the City level
KVK	*Kurinji Vattara Kalanjiam*	

LID	Local Iniative Department	*Departemen Gagasan Setempat*
LIP	Local Initiative Project	*Proyek Gagasan Setempat*
LPD	*Lembaga Perkreditan Desa*	Rural Credit-disbursion Office
MAD	*Musyawarah Antar Desa*	Inter-Village Discussion Forum
MCPS	*Penyedia Jasa Layanan Keuangan Mikro*	Micro Credit Service Provider
MFI	*Lembaga Keuangan Mikro*	Microfinance Institution
MICRA		Microfinance Innovation Center for Resources and Alternatives
MIS	*Sistem Informasi Manajemen*	Management Information System
MoF	*Departemen Keuangan*	Ministry of Finance
MoHA	*Departemen Dalam Negeri*	Ministry for Home Affairs
MoPW	*Departemen Pekerjaan Umum*	Ministry of Public Works
MTR		Mid-term Review
NGO	*Lembaga Swadaya Masyarakat*	Non-Governmental Organization
NMC	*Lembaga Konsultan Manajemen*	National Management Consultant
NPL	*Hutang tak terbayar tepat pada waktunya*	Non-Performing Loans, typically measured as a portion of loans which are overdue past 90 days
NTT	*Nusa Tenggara Timur*	East Nusa Tenggara
OSS	*Keberlangsungan Operasi*	Operational Self Sufficiency
QAG	Quality Assurance Group	*Kelompok Penjamin Mutu*
P4K	*Proyek Peningkatan Pendapatan Petani dan Nelayan Kecil*	Economic Empowerment Project for Small time Farmers and Fishermen
PAR	*Portofolio Beresiko*	Portfolio at Risk
PEMP	*Program Pemberdayaan Ekonomi Masyarakat Pesisir*	Economic Empowerment Program for Coastal Communities
PINBUK	*Pusat Inkubasi Usaha Kecil*	Incubation Center for Small Enterprise
PJOK	*Penanggung Jawab Operasional Kecamatan*	Head of Operation at the Sub-district
PKK	*Program Kesejahteraan Keluarga*	Family Welfare Program
PNPM	*Program Nasional Pemberdayaan Masyarakat*	National Community Empowerment Program
PTO	*Petunjuk Tekhnis Operasional*	Technic Operational Manual
SHG	*Kelompok Swadaya Masyarakat*	Self Help Group
SHPI		Self Help Promotion Institution
SMEs	*Usaha Kecil dan Menengah*	Small and Medium Enterprises
SMMS	*Sanghamitra Mandala Mahila Samakhya*	
SPMS	*Sri Padmavathy Mahila Abyudaya Sangam*	
SPP	*Simpan Pinjam Perempuan*	Women's Savings and lending Group
SVAWTC		*Sri Viswabharthi Association of Women Thrift Cooperatives*
TA	*Bantuan Teknis*	Technical Assistance (includes training, consulting and other technical support)

TKPP	*Tim Koordinasi Pelaksanaan P2KP*	UPP Coordination Team
TM		Task Manager
UEP	*Usaha Ekonomi Produktif*	Productive Economic Businesses
UMR	*Upah Minimum Regional*	Regional Minimum Wages
KDP UPK	*Unit Pengelola Kegiatan KDP*	KDP Activity Management Unit
UPK-BKM	*Unit Pengelola Keuangan BKM*	BKM Financial Management Unit
UPL	*Unit Pengelola Lingkungan*	Environmental Management Unit
UPP	*Program Pengentasan Kemiskinan Perkotaan*	Urban Poverty Progam
UPS	*Unit Pengelola Social*	Social Management Unit
VBI	Village Banking Institution	*Institusi Perbankan Desa*
WB	World Bank	*Bank Dunia*

1. EXECUTIVE SUMMARY

Background and Objectives

1. Access to financial services, and more specifically micro-credit, is playing a more prominent role in the overall poverty reduction strategy of the Government of Indonesia (GoI) and has been raised as a potential complementary component to its newly-launched poverty alleviation flagship program, called the National Community Empowerment Program or *Program Nasional Pemberdayaan Masyarakat (PNPM)*. PNPM is designed to help members of communities to decide and manage their own development activities. PNPM builds upon the work of the Government's Kecamatan Development Program (KDP, implemented via the Ministry for Home Affairs) and its urban sister, the Urban Poverty Program (UPP, implemented via the Ministry of Public Works). KDP has been in operation since 1998 and UPP since 1999.

2. The Government has launched a PNPM Micro-Credit Strategy Formulation Mission to make operational recommendations for the design and implementation of a micro-credit program that will be complementary to the PNPM, building upon lessons learned from UPP's and KDP's micro-credit schemes, as well as national and international good practice experiences in the sector.

3. *Objectives of the Study*. The main objective of the Micro-Credit Strategy Formulation Mission is to outline an operationally grounded strategy for a national micro-credit program that will be complementary to PNPM. The micro-credit component will form one wing of the Government's overall national poverty reduction strategy to address issues of access to finance for the poor as well as to develop the private sector.

4. In formulating the recommendations the Mission attempts to answer the following key questions:

(a) What can be learned from international and Indonesian micro-credit programs to design a micro-credit program as part of the Government's overall poverty reduction strategy? What are the contributing factors which have made these micro-credit programs, especially in Indonesia, successful?

(b) What key features should a micro-credit program complementary to the PNPM include in order to ensure effective outreach to the poor while operating on a financially and institutionally sound basis?

(c) What are the different design options for the microcredit program, weighing trade-offs, pros and cons of different features?

(d) How can a complementary program build upon the microcredit groups already existing in KDP and UPP? What should be the proposed organizational and governance structure for such groups? What would be the linkages, if any, with formal banking institutions?

(e) How can the program effectively address the special needs of the poor and marginalized, which are the target beneficiaries of PNPM?

(f) How can the program effectively address the special needs of poor women for micro-finance?

(g) How would one build in features of Islamic banking?

(h) Would technical assistance or other capacity building activities need to be included in the program? If yes, what types of capacity building, and who would provide it? Preliminary survey findings suggested that PNPM should not only focus on access to finance, but also on the provision of basic training on micro-entrepreneurship and small business management.

(i) What would such a proposed training program cost? How will the training program for micro-businesses best be delivered? How can these training programs be integrated into a broader regional private sector development initiative in Indonesia?

5. Research techniques used in the study include desk reviews of available materials and relevant literature, structured interviews, individual field surveys and focus group discussions with senior program managers, strategic partners, field implementers, and program beneficiaries.

Desk review of available material and relevant literature was conducted from December 2007, with particular reliance on the reviewing of both KDP and UPP procedures and guidelines (list of references attached to the research report), as well as existing studies previously conducted to review the implementation of KDP (GTZ Study, ADB study, others).

Field work for the study was conducted from December 10, 2007 to February 22, 2008 covering the project implementation in Jakarta and three other provinces for each program: (i) for KDP – Central Java, East Java and East Nusa Tenggara (NTT); while (ii) for UPP – Central Java, East Java and South Sulawesi.

Interviews were carried out starting December 2007, meeting more than 300 people (260 of them were beneficiaries of the program) during the project, which finally led to the designing of a recommendation and the completion of this report.

Table 1: List of Respondents's Institutions

	Government	Consultant	Implementing Agency	Financial Sector
National	Bappenas	KDP NMC; UPP NMC		
	Ministry of Home Affairs; Ministry of Public Works	World Bank		
Local	Camat	KM Kab; KM Kab Technis (KDP): KMW, Korkot, Askot (UPP);	UPK	BPD Jateng (KCU Karanganyar)
	Lurah		TPK	BPD Jatim (KCU Ponorogo)
	Kades	KPU	Ketua MAD	BRI (KCU Karanganyar, KCU Ende, KCU Sikka, Unit Kecamatan Kendal, Unit Panekan, Unit Siman)
	PJoK	FK, Faskel	BP UPK	BKK (Badan Kredit Kecamatan) Grobogan
	BPMD/Tim Koordinasi Pemberdayaan Masyarakat	Microfinance Specialist (Province Level)	BKAD	Bekatigade (Ende, Sikka)
				BPR
				Koperasi
				LK URK (Lembaga Keuangan Usaha Kecil)

Analysis of the field survey results was carried out from February 2008 up to March 2008.

Formulation of conclusions and recommendations started in March 2008 and continued up to June 2008, with substantial input from The World Bank team as well as the National Consultants both from KDP and UPP Programs. In formulating its recommendations, the MICRA team sought input from Leesa Shrader and Don Johnston, two senior microfinance experts acknowledged both in Indonesia and internationally. All recommendations, however, remain the responsibility of MICRA alone.

Microfinance in Indonesia

6. The microfinance sector in Indonesia is one of the largest in the world, with more than 20,000 MFIs and several banks providing microfinance services sustainably on a large scale. Still, the sector is highly fractured, and poverty in Indonesia remains persistently high with nearly half of the population living on less than $2 a day. While financial institutions offer micro loans to more than 15 million Indonesians, at least 40 million more still lack access to financial services, living out of the reach of the formal financial sector or are considered unbankable. Several key factors currently prevent expanded MFI outreach to the poor in Indonesia, including lack of access to affordable sources of capital for growth and the legal ability to provide only the most basic banking services.

7. *Summary of Key Findings.* The following is a summary of main findings from the field and desk reviews of KDP's and UPP's current performances:

Key Finding #1: *Despite current program shortcomings, both the KDP and UPP microcredit components have the potential to be transformed into sustainable, pro-poor microfinance activities functioning as a key part of larger microfinance-oriented institutions.*

a) KDP/UPP lending activities have reached 6.8 million people (KDP 1.3 million; direct beneficiaries) in areas covering 33 provinces.

b) In carrying out these activities, KDP and UPP have established the basic human infrastructure, be it to lend to or to supervise the loans of millions of poor and vulnerable, low income households in Indonesia.

c) There is willingness to provide start up capital for micro entrepreneur (UPP).

d) At the bottom two levels (implementation and immediate supervision) of the organization created to implement the KDP and UPP microcredit components, the mission team consistently found staff who, with proper training, compensation, supervision, and incentives, would be quite capable of operating a sustainable microfinance activity that continues to reach poor households on a large scale.

e) Despite inadequate policies, operating procedures, training, and product pricing policies, some KDP micro credit units and even more UPP micro credit units continue to operate with their remaining capital, and could perform admirably.

Key Finding #2: *Field study results indicate continuing demand for KDP/UPP microcredit from low-income borrowers, most of whom have few or no alternative sources of credit.*

a) Field study results indicate that the KDP and UPP microcredit components are perceived by participants to have positive impacts both on the business side as well as on the personal/household side. Around 77% and 79% of KDP and UPK beneficiaries respectively said that their household income increased as a result of their program participation. The increase of income is brought by higher production scale for 59% and 67% of KDP and UPP beneficiaries respectively. Children educational levels and beneficiaries' access to finance are improved; and unemployment rates are reportedly decreased (with the exception of Nusatenggara Timur).

b) Beneficiaries' general access to financial services is very limited and hinges on several key factors, such as availability of financial institutions and the fulfilling of collateral requirements.

c) The survey also indicates that the demand for KDP/UPP finance is high. Only 20% of KDP respondents and 3.5% of UPP respondents surveyed reported access to credit at other institutions.

d) Although almost half of KDP and UPP beneficiaries have saving accounts in formal financial institutions, this access to savings services does not appear to have led to improved credit access. A total of twenty-four percent (24.2%) of KDP beneficiaries and 17.9% of UPP beneficiaries save their money in their respective groups.

e) Key competitive advantages for these programs relative to local competition, reportedly include simplified procedures and the absence of formal collateral

requirements, a strong sense of community ownership as well as value for the elements of transparency and community participation.

Key Finding #3: *Despite the positive achievements of these programs, both the national statistics and field studies reveal substantial shortcomings in both outreach and institutional development that must be overcome in order to transform the programs.*

Outreach

a) As a consequence of their moral obligation, group leaders usually prioritize selecting members of his/ her group based on repayment capacity and not pro-poor criteria, which is common in solidarity group lending. While this is, in most respects, a positive finding (i.e., group leaders care about group repayment), it may limit outreach to poorer clients if left unchecked and therefore requires additional strategy for reaching the productive poor.

Institutional Development

a) The range of portfolio quality among sampled KDP and UPP microfinance activities (9 out of 1721 for KDP, 9 out of 834 for UPP) is represented by the percentage of non-performing loans (NPL). NPL is a loan that is in default or close to being in default. A high NPL rate signifies a low loan portfolio quality. Review of credit of KDP shows a wide range of NPL(0% to 84%) which indicates a relatively varied portfolio quality among units. The highest NPL was found in KDP in East Nusa Tenggara. Findings among UPP show a lower range of NPL (0% to 28%). In KDP, NPL levels vary significantly with the three samples in East Java having the highest portfolio quality. Meanwhile among UPP units delinquency was reportedly increasing due to high field staff turnover and weak delinquency management. Both national consultants have conducted a satisfactory mapping classifying kecamatans (category A to D) that measure potential growth of each kecamatan. However, these measurements are not adequate to assess the performance of MFIs based on their portfolio quality. Therefore, a thorough evaluation or appraisal should be conducted to review revolving fund activities and records to be able to assess the portfolio quality. The national performance of each KDP and UPP kecamatans were measured by repayment rate (beside all other measurements). At KDP their repayment rates for UEP and SPP were 85% and 94% respectively.

b) UPP and KDP microfinance performance still depend largely on government subsidies and are not sustainable at present. Here, UPP is slightly ahead, but both institutions need to improve efficiency, reduce delinquency, and increase interest income.

c) Low pay and poor training, supervision, and human resource management (i.e., staffing to match the level of activity, capacity to grow and willingness to grow) limits service and quality.

d) Lack of legal status adversely impacts UPP and KDP micro credit institutional operation and sustainability by making it difficult for formal financial institutions to lend to them or make service arrangements for other microfinance products.

e) Monitoring and evaluation systems of both KDP and UPP for microcredit are weak, beginning with basic definitions of profit/loss and accounting for bad debt. For the surveyed microfinance activities, the reports of several units painted a rosier picture than the underlying data should have indicated.

f) Best practice in Indonesia typically includes more frequent repayment (at least weekly) and a loan size range of Rp 1-3 million for this sector in order to ensure higher repayment rates. However, this presents an administrative challenge for KDPs and UPPs whose human resource capacity and working hours are restricted by the limited staff remuneration and benefits.

g) From the field survey, 91.1 % of KDP respondents and 81.4% of UPP respondents have been assessed prior to the loan disbursement. However, external controls over verification are limited and verification rates tend to decrease with repeat loans, which can compromise loan repayment. Most cases of client's inability to repay loans are ultimately attributable to the program staff's inability to make sound loan decisions.

h) The performances of both KDP and UPP loan products and services in meeting clients' demands are generally weak; many clients would like larger loans and different repayment schedules.

i) Regular group meetings are not consistently enforced throughout the program implementation and are usually held only when there is a loan repayment due.

j) Internal control is not institutionalized and is typically carried out by volunteers, who often lack the knowledge and authority to identify problems and respond correctly. These volunteers are selected from communities through MAD to become members of Badan Pengawas Unit Pengelola Keuangan, which principally is a body to supervise UPK.

8. ***Possible Program Models:*** This study has identified five options for the future development of the microcredit programming for KDP and UPP all of which include the separation of microfinance from other grant-based programming, in conformance with historical recommendations related to these programs. These options are briefly outlined below, with the leading recommendation elaborated in more detail in the following section.

9. ***Option 1: Executing Program Credit through Banks.*** This is a common methodology used throughout government credit programming which extends loans to existing self-help groups through commercial banks, often with a supporting government credit guarantee component. The PEMP (*Program Pemberdayaan Ekonomi Masyarakat Pesisir*) of the Ministry of Marine Affairs and Fisheries is a relatively successful version of this program, which works in cooperation with Bank Bukopin.[1] In this model, neither the bank nor the sponsoring government ministry plays an active, ongoing role in group formation.

[1] See MICRA "Rapid Evaluation Report On Government Community Development Operations: *Microfinance and Microcredit Projects" 2007.*

10. ***Option 2: Linking Community Groups to Banks.*** This approach is outlined in section 4.2.2 below, pointing to the examples of BI's successful programming with GTZ ProFI and the P4K (*Proyek Peningkatan Pendapatan Petani dan Nelayan Kecil*). P4K, originally sponsored by IFAD and ADB, is an on-going government Project under the Ministry of Agriculture, which actively uses agricultural extension workers (originally trained by Bina Swadaya, an NGO with a long experience in group credit) to form self-help groups at the village level in rural communities, and links them effectively to the formal financial sector, in this case, BRI. BRI acts as financial supervisor, judging when groups are ready to receive credit, and supervising the repayment performance of groups (and the extension workers involved). Both direct and indirect subsidies continue to be used in this approach.

11. ***Option 3: Devolving Ownership and Management to Village Level.*** This approach is referred to in the report pointing to the examples of the Badan Kredit Desa (BKD) and Lembaga Perkreditan Desa (LPD). These two forms of existing, village-owned microfinance institutions have a long history, dating back more than 100 years. The LPD system in Bali encompasses more than 1,200 village-owned institutions and has been acknowledged as an innovative model of village banking globally.[2] There are currently more than 3,000 BKDs located mainly in villages in Java. Both institutions receive financial supervision: the BKDs from BRI, and the LPDs from a combination of local government and Bank BPD Bali. Of the two, the LPDs have by far the stronger tie to the local people.

12. Success for both of these legal forms is closely linked with population density, and the fact that there should be a minimum of 50 active borrowers in the village to ensure that there is sufficient turnover to sustain the funds. The success of the LPD in Bali has also been closely tied to the high level of social cohesion and strength of village governance. Both institutions are owned and managed by village bureaucracy and operate on a part-time basis only, with low fixed and overhead costs. It is clear that the high level of local government investment in the LPD, in terms of management capacity building and framework conditions, has produced a positive effect, as LPD has a much higher level of dynamism than the BKD, which has not broadly evolved into effective financial intermediaries. For the BKDs, BRI has interpreted its role as supervisory and has made relatively few contributions to institutional development.

Option 4: Leading Formation of Cooperatives or Badan Usaha Milik Desa (BUMDES). In practice, the legal forms of BKDs and LPDs may not be available to most KDP/UPP microfinance units. When questioned on the desired future direction of their activities, UPK staff and village leaders most often cited converting KDP/UPP microfinance to the legal forms of cooperatives or BUMDes. MICRA has completed a number of studies related to the formation of new, small individual cooperatives through government program-related credit lines. The experience with ultimate sustainability of the cooperatives has been extremely variable and generally negative. Most "program-based" cooperatives languished and died, while only a few have formed strong operational links within communities and with institutional partners, including commercial banks (esp. Bank Bukopin). This type of

[2] See "ProFI Microfinance Institutional Study", by Detlev Holloh, 2001, for more detailed information on these institutions.

formalization strategy could target only the larger and more financially viable village level programs and would rely heavily on an initial framework of startup support.

13. ***Option 5: Determining a supervising financial institution, and giving the Supervising Financial Institution Ownership or (at Least) a Profit Stake in the new Microfinance Institutions.*** While Options 3 and 4 above bring the potential benefit of community involvement, the potential supervisory/support structure is quite weak. In most cases (again, LPDs are a partial exception), the choice of a model that emphasizes community ownership will tend to sacrifice supervision quality, professional development of personnel, access to outside funding, innovation, and, thus, sustainability. In most cases, a sustainable "grassroots" microfinance delivery model requires system-level management, training, funding, and development from competent microfinance providers with appropriate financial incentives for expansion and sustainability. Indonesia's most successful poverty-oriented microfinance institutions, including the Grameen replicators, rely on this model, using a top-down structure to provide appropriate, high-quality financial services at the community level.

14. ***Recommended Future PNPM Program Model***: The recommended approach to future PNPM programming related to microfinance is in essence Option 5 above: to consolidate and institutionalize the microfinance fund operations of KDP and UPP, based on a process similar to that outlined in the LIP Bosnia and Herzegovina case presented in 4.1.4 below. This award-winning World Bank program was delivered in participation with theMinistry of Finance in Bosnia, to build a sustainable and vibrant microfinance industry where none has previously existed. The situation is similar to Indonesia in many ways. Here, the sustainable institutional microfinance infrastructure to develop and sustainably operate the KDP/UPP – derived village banks or community-managed loan funds (CMLF) does not exist. However, a potentially strong network of village funds could be linked into professional, microfinance institutions at the regional (provincial or *kabupaten*) level to carry on and expand the work of the KDP and UPP facilitators, consultants and UPK staff.

15. PNPM could follow the Local Initiative Project (LIP) model of conducting a public tender amongst all institutions deemed potentially qualified to assume the management of regional village CMLF, including BPR, Bank Pembangunan Daerah (BPD), commercial banks, NGOs, second-tier cooperatives, specialized state-owned entities, etc. Applicants would have to demonstrate their understanding of the market, sustainable business model, competency in the village banking model and overall business strategy. As the programming densities performances are highly varied by region, it is recommended that applicants submit proposals which clearly show their ability to sustainably support and manage the activities over time. It is recommended that most tenders be carried out at the provincial level with qualified institutions eligible to bid for multiple provinces.

16. In practice there will be a need for a mapping and tender preparation process in order to determine the specification of tender and relevant performance targets. Each province's tender or tenders will require its own mapping and preparation following standards set out by the key stakeholders. Mapping should include market and organizational assessment and potential.

17. PNPM would need to provide a comprehensive support program for the institutions winning the competitive bidding process, which covers:

- Immediate, substantial and universal program changes, including improved profit/loss and portfolio quality measurement at the local levels coupled with substantially-increased interest rates and re-organization of KDP/UPP staff to separate financial "institution" personnel from other program activities as soon as possible;
- Fresh capitalization to invest in village funds which demonstrate a sound performance;
- Operational subsidies to be provided on a declining basis over the first three years, to ensure that institutions could build scale and be expected to cover all costs by the end of year three;
- Technical assistance in village banking operations;
- Uniform management information system for all institutions
- Uniform standards and procedures for operation (e.g. a limited menu allowing choice between standard village-banking or Grameen-replication models), reporting, transparency, performance measurement, and the circumstances under which new institutions should be brought in should the existing institutions' performance fail; and
- Possible funds for a legal/ policy program to promote a conducive operating environment for village banking.

18. In the LIP model in Bosnia, new institutions were provided with clear performance targets related to outreach to the poor, portfolio quality, scale, efficiency and profitability, as well as more qualitative targets related to governance and internal capacity building. If these progressive targets were met over a three to five year period, all funds placed in the institution would be converted to equity owned by the microfinance institutions, to ensure the long term operation of fully sustainable, professionally run institutions, serving the poor at scale. The relative advantages and disadvantages of this model are elaborated in section 5.3.1.

19. The project budget under the recommended model should cover costs in various levels to convert the revolving fund to a sustainable microfinance beyond program period. PNPM would need to provide a comprehensive support program for the institutions winning the competitive bidding process, which includes:

- Fresh capitalization to invest in village funds, which demonstrate sound performances; The size of the micro credit portfolio fund allocated for each location should consider long term institutional sustainability, where the income from loan portfolio should have the capacity to cover operational expenses, cost of fund, inflation, loan loss reserve as well as institutional capitalization and growth. A key determinant of financial institution selection regards willingness and ability to provide fresh funds once sustainability has been reached.

- Operational subsidies to be provided to financial institution intermediaries on a declining basis over the first three years, to ensure that institutions could build scale and be expected to cover all costs by the end of year three; the operational subsidies should be calculated based on the mapping result.

20. However PNPM should also cover other costs at the national level to promote a conducive environment to the sustainable model and to ensure conformity of reporting, transparency, improved performance and the ability to bring in new or existing institutions should performance fall;

Program level:

- Technical assistance in village banking operations should be provided by the program. Depending on the capacity of the selected financial institution intermediaries, technical assistance can be provided in collaboration with a third party.
- Management information system (MIS) including implementation phase and training.
- Possible funds for a legal/ policy program to promote a conducive operating environment for village banking.

21. It is recommended that the Pilot Phase includes three to five regional institutions. The total amount needed to start the Pilot Phase of five regional institutions (5 MFIs) would be around USD 6.53 million for a two-year-project duration. It is to include personnel (internal staffing), technical assistance, capital to MFIs, and operating support costs. It is expected that MFIs would be able to leverage financing portfolio by the end of the program at the ratio of 2:1. It is also expected that strong performance of the pilot program would be instrumental in drawing additional private sector funding for the expansion of the program as part of an innovative means to reach this unbanked sector.

2. INTRODUCTION

2.1. BACKGROUND

22. In Indonesia, the Government has emphasized increasing access to financial services as a priority component of its financial sector reform agenda. As described in the World Bank's report on "Making the New Indonesia Work for the Poor", significant barriers in accessing loan and saving instruments remain for households and enterprises of all sizes, making them vulnerable to economic shocks. Extending the reach of financial services to the poor could have a major impact upon employment generation and poverty reduction. Recent studies and surveys, such as those of the Central Bureau of Statistics (BPS), Bank Rakyat Indonesia (BRI), the Asia Foundation, IFC-PENSA and Asian Development Bank (ADB), point out to varying degrees the lack of household and institutional access to financial services, despite high demand.

23. Access to financial services and more specifically, micro-credit, is playing a more prominent role in the Government's overall poverty reduction strategy and has been raised as a potential complementary component to the Government's newly-launched poverty alleviation flagship program, the National Community Empowerment Program or *Program Nasional Pemberdayaan Masyarakat (PNPM)*. PNPM is designed to empower communities to decide and manage their own development activities. The PNPM builds upon the work of the Government's Kecamatan Development Program (KDP) and its urban sister, the Urban Poverty Program (UPP). KDP has been in operation since 1998 and UPP since 1999.

Table 2: Micro-credit Program Description

	PROGRAM PENGEMBANGAN KECAMATAN	PROGRAM PENANGGULANGAN KEMISKINAN PERKOTAAN
Project Name in English	Kecamatan Development Program	Urban Poverty Program
Ministry	Ministry of Home Affairs (MoH)	Ministry of Public Works (MoPW)
Objective	To alleviate poverty based on community empowerment thru capacity building, local government, and social and economy infrastructure development.	To improve services for the urban poor by strengthening both community and local government capacity for responsive service delivery in urban areas.
Project Implementation	- Phase 1 (1998 – 2002) - Phase 2 (2003 – 2005) - Phase 3 (2005 – 2006) - KDP Mandiri (adopted in PNPM)	- Phase 1 (1999 – 2004) - Phase 2 (2002 – 2008) - Phase 3 (2004 – 2009) - UPP PNPM (2007)

Source: KDP and UPP Documents

24. Both KDP and the UPP have micro-credit components, financed through the community block grants. However, the specific features of the two micro-credit programs vary and both programs have instituted changes in the micro-credit procedures with each phase of the programs. KDP's micro-credit activities have started since 1998 and up to early 2008 have been able to allocate a total of IDR 1.16 billion, while UPP has allocated a total of IDR 650 million for micro credit. The following table shows the detailed program achievements:

Table 3: Micro Finance Activities Program Achievements

MICRO FINANCE ACTIVITIES PROGRAM ACHIEVEMENTS UP TO DECEMBER 2007				
		Indonesia	**KDP**	**UPP**
Kelurahan/Group		62,808	34,103	126,000
	percent to total		54%	
SubDistrict		5,263	1,721	959
	percent to total		33%	18%
District		450	268	249
	percent to total		60%	55%
Province		33	30	33
	percent to total		91%	100%
Number of loans/group loans			1,339,942	250,833
Total Value of Program			10,000,000,000,000	1,000,000,000,000
Total Value of MF Activities			1,160,000,000,000	650,000,000,000
	percent to total		12%	65%

25. Past internal and external reviews of the micro-credit portfolios of KDP Phase I and UPP Phase I uncovered many problems in design and implementation, leading both programs to cut back on new infusions of funds for micro-credit. Both programs were not designed as free-standing micro-credit programs, and mixing the features of participation, granting, and targeting the poor, were considered inconsistent with the running of a proper micro-credit component.

26. Based upon earlier reviews of KDP and UPP, other problems often reported from the field about the KDP and UPP microcredit programs are:

(i) The community groups or the group leaders do not consider the poor especially the poorest credit worthy. Most of the loans go toward the economically productive in the community.

(ii) The cash injections are relatively small, thus some borrowers are able to increase their productive capacity marginally but not enough to have a major poverty alleviating impact. This is especially true of the women's groups (Simpan Pinjam Perempuan / SPP).

(iii) Groups who have experienced high repayment rates and have a proven track record in managing credit must often wait a long time for funds again as credit revolves around the community. Thus, there is a high demand for credit, but limited supply.

(iv) Villagers need business management and skills training, not just credit, to succeed in business.

27. With the majority of KDP and UPP funds currently being allocated for economically productive small-scale infrastructure, attempts have been made in the past to run separate complementary programs of micro-credit. But these separate programs have never materialized, e.g. the WB-supported microfinance support programs or links with formal banking institutions such as BRI. These attempts have failed due to several reasons including the lack of concerted efforts to build strong complementary programs, lack of Government buy-in to these programs, and the expense required for linking with formal banking institutions. In the next six months, the UPP program will be in a transition period, while the UPK performance will be carefully monitored.

28. The Government has launched a PNPM Micro-Credit Strategy Formulation Mission to make operational recommendations for the design and implementation of a micro-credit program that will be complementary to the PNPM, building upon lessons learned from UPP's and KDP's micro-credit schemes, as well as national and international good practice experiences in the sector. For this purpose, the World Bank and the Decentralization Support Facility contracted Microfinance Innovation Center for Resources and Alternatives (MICRA) to conduct a micro-credit strategy formulation study from December 10, 2007 up to March 31, 2008.

2.2. DESCRIPTION OF RESEARCH

2.2.1. Objectives

29. The main objective of this Micro-Credit Strategy Formulation Mission was to outline an operationally grounded strategy for a national micro-credit program that will be complementary to PNPM. The micro-credit component will form one wing of the Government's overall national poverty reduction strategy to address issues of access to finance for the poor and develop the private sector.

30. In formulating the recommendations the Mission attempts to answer the following key questions:

(a) What can be learned from international and Indonesian micro-credit programs to design a micro-credit program as part of the Government's overall poverty reduction strategy? What are the contributing factors which have made these micro-credit programs, especially in Indonesia, successful?

(b) What key features should a micro-credit program complementary to the PNPM include in order to ensure effective outreach to the poor while operating on a financially and institutionally sound basis?

(c) What are different design options for the microcredit program, weighing trade-offs as well as pros and cons of different features?

(d) How can a complementary program build upon the microcredit groups already existing in KDP and UPP? What should be the proposed organizational and governance structure for such groups? What would be the linkages, if any, with formal banking institutions?

(e) How can the program effectively address the special needs of the poor and marginalized, which are the target beneficiaries of PNPM?

(f) How can the program effectively address the special needs of poor women for micro-finance?

(g) How would one build in features of Islamic banking?

(h) Would technical assistance or other capacity building activities need to be included in the program? If yes, what types of capacity building, and who would provide it? Preliminary survey findings suggested that PNPM should not only focus on access to finance, but also on the provision of basic training on micro-entrepreneurship and small business management.

(i) What would such a proposed training program cost? How will the training program for micro-businesses best be delivered? How can these training programs be integrated into a broader regional private sector development initiative in Indonesia?

2.2.2 Methodology and Data Collection Techniques

31. The research methodology was organized to include a comprehensive review of the existing programs at key operational levels, as well as a brief overview of relevant international and Indonesian models and best practices of micro-credit programs for sustainable community development. The study covered four key areas:

1) Institutional level performance (past and current) of KDP and UPP at national, regional and local levels;
2) Limited review of program beneficiaries and non-beneficiaries in targeted communities to assess program performance and impact;
3) Review of local financial institutions operating in the same areas as KDP/UPP;
4) Review of best-practices and programs for community-based micro-credit nationally and internationally.

32. The study included the following phases of implementation:

Workplanning and Preparation

The team started the process first week of January 2008 by preparing a detailed work plan and timetable in consultation with the World Bank and key stakeholders. The work plan included the target locations being studied, as well as related organizations and persons to be interviewed. Research tools, such as an interview guideline, guidelines for FGD and MFI rapid appraisal, and structured questionnaires were also developed during this phase.

Desk Review

The team conducted a desk review of KDP and UPP program documentation which included project planning and design documents, appraisals, operational manuals, performance reports, impact studies and program evaluations focusing specifically on the micro-credit components starting December 2007. A desk review of documentation related to international and Indonesian best practices and experience related to sustainable community-based micro-credit programs was conducted simultaneously. The team also reviewed documents related to Islamic microfinance in Indonesia.

Pilot Testing

The team then tested the research tools to ensure that they addressed the research objectives and were relevant to the real situation in the field. The pilot testing was conducted in Serang, Cikeusal Sub-district for KDP; and in Poris Pelawat, Cipondoh Sub-district, Tangerang, for UPP on Jan 4, 2008. After the pilot testing, revisions were made based on stakeholder suggestions and internal team feedback. Final research instruments are included in the report annexes.

Data Analysis

The team analyzed data gathered from the relative program MIS databases at the national level and/or existing data runs from previous surveys on program performance indicators. An analysis on data and information related to similar micro-credit programs and Islamic microfinance programming in Indonesia was also conducted. These data were collected from international benchmarking documents (i.e. Microbanking Bulletin), MICRA rating reports, Bank Indonesia publications and other statistical sources (see Annexes for full references).

Key Stakeholder Interviews

In order to better understand the strategic and operational context of potential PNPM micro-credit programming, the team conducted structured interviews with key stakeholders and experts in Jakarta, including the World Bank staff and senior staff of the implementing Ministries (Ministry of Public Works for UPP and Ministry of Home Affairs for KDP). The same interviews were also conducted with experts and key stakeholders from both conventional and Islamic community-based micro-finance in Jakarta (see Annexes for full list of persons met).

Field work

Field work was conducted in three provinces to jointly review operations of both KDP (Central Cava, East Java, and East Nusa Tenggara/NTT) and UPP (Central Java, East Java, and South Sulawesi) programs. Field research was based on structured interviews and FGD tools with key stakeholders, including government officials, financial management units, project facilitators, bank officers, community leaders, and program beneficiaries. Two independent teams were set up to review UPP and KDP programs in the field, respectively, to assess both the supply of credit and the demand for future services, as well as their impacts at the beneficiary level. Each team consisted of two field researchers responsible for

reviewing and analyzing the program performance and operations, as well as interviewing other financial service providers and program beneficiaries and non-beneficiaries in the areas being studied.

Report Development

Finally, all data and information gathered were synthesized during a series of internal review sessions to produce the first draft report. Key concepts and recommendations were discussed with the World Bank. Draft reports will be circulated to both the World Bank and relevant ministries, including Bappenas. After formal presentation of draft findings and taking into account stakeholder feedback, the final report was constructed.

2.2.3. Locations

33. Field work was conducted in three provinces for UPP, Central and East Java and South Sulawesi, and three provinces for KDP program, Central and East Java and East Nusa Tenggara. In those four provinces, 9 villages, 17 sub districts 13 districts were visited. We interviewed 474 people; for KDP program 174 beneficiaries (questionnaire and FGD), and 103 people from different institutions; while under the UPP program met 153 beneficiaries, and 44 people from different institutions. Both qualitative and quantitative data on clients' perception and satisfaction have been collected, in addition to detailed and specific data program administration and management. Appraisals to administration and management of micro finance activities have also been conducted. Findings from this field visit will and should not be used to generalize the notion toward the whole program since the the sample size taken under review were minimum (less than 0.3%)

34. Both demand and supply-side studies were completed simultaneously in these provinces to ensure relevance and comparability of data. Selection of districts was made after desk review and based on the following criteria (in order of importance):

1) Mix of provinces in Java and outside Java Island;
2) Availability of a mix of strong, medium and weak groups of beneficiaries and overall program performance; and
3) Areas with innovation for program sustainability, such as a channeling program under UPP.

Table 4: Target Locations for KDP Program

Category	Sub-district	District
Central Java		
A	Karang Anyar	Karang Anyar
A	Kebak Kramat	Karang Anyar
B	Grobogan	Grobogan
East Java		
A	Kendal	Ngawi
A	Siman	Ponorogo
B	Panekan	Magetan

NTT		
A	Ende Selatan	Ende
A	Nanggapanda	Ende
C	Lela	Sikka

Table 5: Target Locations for UPP Program

Category	Village	Sub-district	District
Central Java			
A	Denggungan	Banyudono	Boyolali
A	Gumokrejo	Teras	Boyolali
B	Dukuh	Sukohardjo	Sukoharjo
East Java			
A	Tales	Ngadiluwih	Kediri
A	Pare	Pare	Kediri
C	Pulo Lor	Jombang	Jombang
South Sulawesi			
A	Lembang Parang	Barombong	Gowa
A	Tamallaba	Ujung Tanah	Makasar
C	Ujung Tanah	Ujung Tanah	Makasar

Categorization of UPK KDP A, B, C:

1. Category A: UPK with minimum balance > IDR 300 million; and total mapping result > 6
2. Category B: UPK with minimum balance up IDR 300 million; and total mapping result > 6
3. Category C: UPK with minimum balance > IDR 300 million; and total mapping result less or equal to 6
4. Category D: UPK with minimum balance up IDR 300 million; and total mapping result less or equal to 6

Sources: Penjelasan X Pengelolaan Dana Bergulir Program Pengembangan Kecamatan (PPK), Tim Koordinasi Program Pengembangan Kecamatan Jakarta, 2005

35. During field work, the research team interviewed stakeholders of each program and groups of beneficiaries with both strong and weak operational and financial performances in order to gain better understanding of future programming needs. The selection of strong and weak groups of beneficiaries was based on pre-determined indicators,

including outreach, repayment and other factors, as well as data presented in the KDP and UPP rating report dated June 2007 for each institution in the selected areas.

36. Please note that considering the limited number of sample from the total program locations and units, the findings are solely representative of the conditions of the KDP and UPP in sampling areas.

Table 6: List of Institution Interviewed

Geographical Level	INSTITUTION			
	Government	Consultant	Implementing Agency	Financial Sector
National	Bappenas	KDP NMC; UPP NMC		
	Ministry of Home Affair; Ministry of Public Works	World Bank		
Local	Camat	KM Kab; KM Kab Technis (KDP): KMW, Korkot, Askot (UPP);	UPK	BPD Jateng (KCU Karanganyar)
	Lurah		TPK	BPD Jatim (KCU Ponorogo)
	Kades	KPU	Ketua MAD	BRI (KCU Karanganyar, KCU Ende, KCU Sikka, Unit Kecamatan Kendal, Unit Panekan, Unit Siman)
	PJoK	FK, Faskel	BP UPK	BKK (Badan Kredit Kecamatan) Grobogan
	BPMD/Tim Koordinasi Pemberdayaan Masyarakat	Microfinance Specialist (Province Level)	BKAD	Bekatigade (Ende, Sikka)
				BPR
				Koperasi
				LK URK (Lembaga Keuangan Usaha Kecil)

3. KDP AND UPP PROGRAM REVIEWS AND FINDINGS

3.1 PROGRAM SUMMARIES

3.1.1. Kecamatan Development Program (KDP)

37. ***Background***. The Kecamatan Development Program (KDP) is a national program of the GoI aimed in general at alleviating poverty, strengthening local governments and community organizations, and improving public governance, and in particular strengthening the capacity of communities to plan and manage local development. KDP focuses on supporting Indonesia's poorest rural communities by encouraging their members to engage in a participatory planning and decision-making process prior to receiving block grants to fund their self-defined development needs and priorities. The program provides block grants of approximately Rp. 500 million to Rp. 1 billion to sub-districts (Kecamatan) depending on the size of the population, except for sub-districts in Aceh and Nias which can receive additional grants of up to Rp. 7 billion for post-disaster reconstruction activities.

38. ***Program Locations and Outreach***. KDP covered 34,103 of the poorest villages in Indonesia, or approximately 54% of all villages, during the 1998 to 2006 program implementation. A total of US $77.6 million in loan funds has been distributed to poor communities in these villages, consisting of US$31 million for women's groups and US$46.6 million for mixed groups (UEPs). The mixed groups had a repayment rate of 85%, as compared to the women's microcredit groups (SPP) of 94%3.

Table 7: KDP Outreach, 1998 – 2007

GEOGRAPHICAL LEVELS	KDP COVERAGE			TOTAL IN COUNTRY	TOTAL KDP COVERAGE TO DATE (%)
	KDP I	KDP II	KDP III		
Provinsi	22	30	30	33	91%
Kab/Kota	130	246	268	450	60%
Kecamatan	986	1354	2006	5263	38%
Desa	20,671	22,010	34,103	62,808	54%

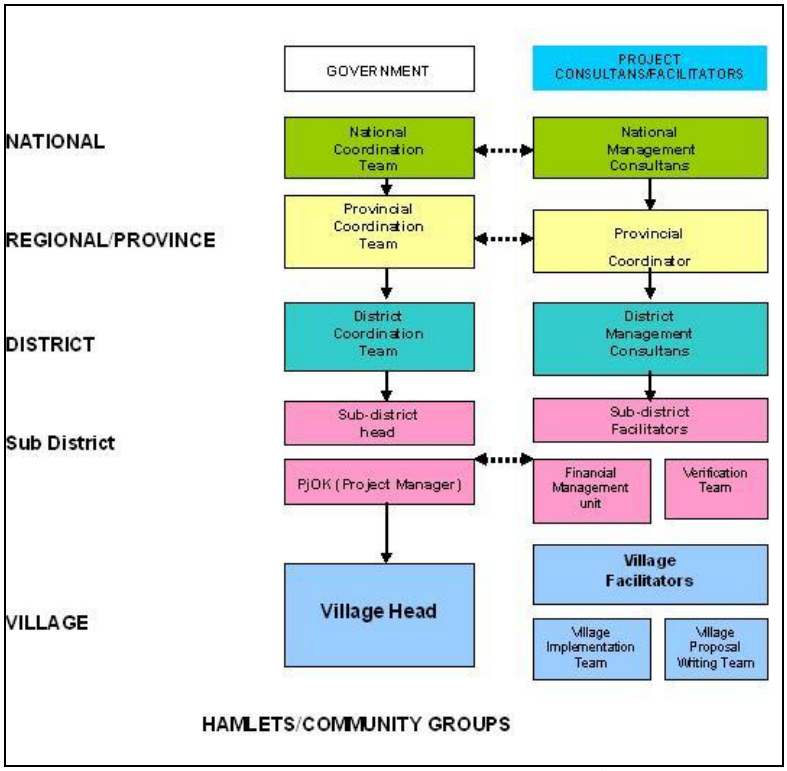
Source: KDP homepage www.ppk.or.id

39. ***Management Structure***. The Department of Community Development of MoHA is the office officially mandated with the management of KDP, although teams of facilitators and consultants at national and local level provide practical implementation support, oversight technical support and trainings. A national coordination team representing various ministries is appointed to oversee and monitor the overall program

[3] See Ministry of Home Affairs and KDP NMC 2006 annual report.

implementation at national, provincial, and district levels. Figure 1 below shows the management structure of KDP.

Figure 1: Management Structure of KDP



Source: Program Pengembangan Kecamatan Paket Informasi Tahun 2007 (Information Packet year 2007)

40. The Unit Pengelola Kegiatan (UPK), the kecamatan-based activity management unit in the KDP program, manages all activities including micro finance, environment (public works) and social activities. The MAD, or Musyawarah Antar Desa, is a representative body elected by the representative of each village in the kecamatan to facilitate the village forum to supervise the UPK effectively in implementing the programs. UPK reports are copied and sent to Camat (head of Sub District) or the Penanggungjawab Operasional Kecamatan (PJOK), the official appointed by the Camat to supervise all KDP activities in the sub district.

41. In KDP, UPK staff are elected through MAD forum and must consist but not limited to three people (i.e. chair person, secretary and treasurer) selected from candidates proposed by each village. Most of UPK staff hold university degrees. In the selection process the candidate must take written tests and be interviewed by PJOK.

42. For program purposes, the UPK submits reports to different stakeholders including MAD, Camat/PJOK, Sub-district facilitators, district consultant office, and project coordination team at district level. Supervision and coordination functions at all levels of the program are carried out by consultants based at the district, regional, and national levels.

43. ***Design and Characteristics***. KDP emphasizes the following principles in the program implementation:

a) **Transparency:** All program activities are conducted transparently and all decisions taken collectively by members of the community and progress are reported to the public.

b) **Pro-poor Approach:** Every activity is orientated to improve the welfare of the poor in every target community and shall consider the needs of the poor. The poor shall be involved in every program planning, implementation and maintenance activities, as well as in every public awareness campaign.

c) **Participation/Inclusion:** The program emphasized community active participation, especially among the poor and women. All members of the community shall be involved in local decision-making process.

d) **Competition for Funds:** All eligible communities or villages must compete in an open and fair manner in order to be granted KDP funds.

e) **Decentralization:** All program activities aim at facilitating members of communities to make their own collective choices on community projects they need and want and to manage them by themselves.

38. KDP works to maximize community participation throughout the project cycle through the following activities:

a) **Information dissemination and public awareness.** Information on KDP is disseminated through various workshops held at the provincial, district, sub-district and village levels.

b) **Participatory planning process.** Participatory planning process is done at the sub-village, village and sub-district levels. Members of the village communities elect two facilitators – a man and a woman – who will then assist them in the planning process and public education on the program. The facilitators are also responsible in organizing group meetings, including meetings for women's groups, to discuss the needs of the community and its development priorities. In addition, KDP also appoints social and technical consultants at Kecamatan and district levels to assist with the program planning, implementation and public education on the program.

c) **Community projects selection.** Project proposals to be funded through KDP are selected by members of the community at the village and sub-district levels. Every member of the community can propose a project and may attend open meetings to select the community projects. An inter-village forum composed of elected village representatives makes the final decisions on project funding. Project menus are open to all productive investments except for those on a short negative list.

d) **Villagers implement their own projects.** KDP community forums select members to be part of an implementation team to manage the projects. KDP technical consultants help the village implementation team with infrastructure design, project

budgeting, quality verification, and supervision. Workers are hired primarily from the beneficiary village.

e) **Accountability and reporting on progress.** During implementation, the implementation team must report on progress twice at open village meetings before every fund disbursement. At project completion, the implementation team hands over the project to the village through a village operations and maintenance committee during a final meeting.

f) Implementation of KDP in post-disaster areas (i.e. Aceh and Nias) uses special procedures that are based on Post-disaster Rehabilitation Guidelines and made to speed up rehabilitation and reconstruction-related activities in those areas.

3.1.2. Urban Poverty Program (UPP)

44. ***Background***. The Urban Poverty Program (UPP) is a national program of the GoI aimed at alleviating poverty in urban areas. UPP aims specifically to improve services for the urban poor by strengthening the capacity of both communities and local governments to manage UPP development funds and deliver responsive, effective and transparent services to the poor in urban areas. UPP provides capacity building to urban communities and local community-based organizations to articulate and voice out the development needs of members of their communities. The program provides block grants to urban communities for infrastructure development and social and economic-related activities. The UPP program targets villages in urban areas. From 1999 to 2007, UPP provided services in all 33 provinces of Indonesia, including 249 districts and 834 Kecamatan.

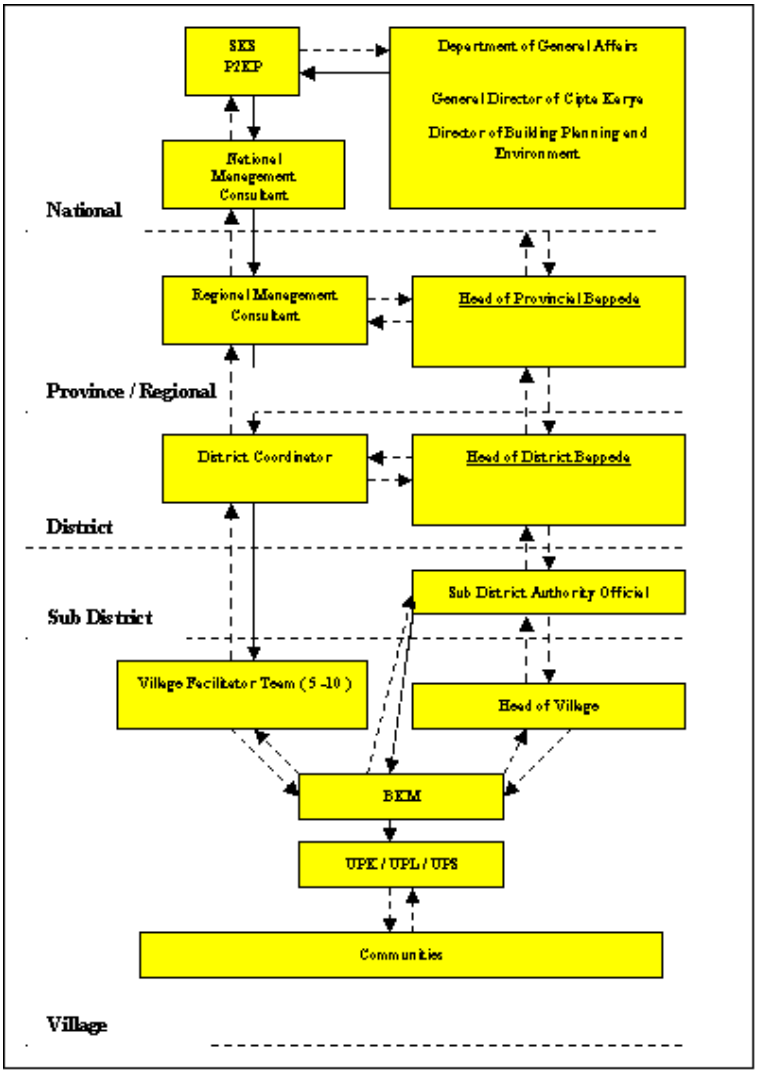
Table 8: UPP Outreach

GEOGRAPHICAL LEVELS	TOTAL IN COUNTRY
Province	33
Kab/Kota	249
Kecamatan	834
Groups	4400

Source: UPP Program Management Team

45. ***Management Structure***. UPP implementation is under the responsibility of the Ministry of Public Works since 1999. As with KDP, teams of facilitators and consultants at national and local levels provide practical implementation support, oversight technical support and trainings. The program consultants for UPP are also funded directly by World Bank programming. A national coordination team representing various ministries is appointed to oversee and monitor the overall program implementation at national, provincial, and district levels. Figure 2 below shows the management structure of UPP.

Figure 2. Management Structure of UPP



46. The Unit Pengelola Keuangan (UPK), the kelurahan-based financial management unit in the UPP program, deals solely with microfinance activities. This differs from the UPK in KDP, which manages all activities including environment (public works) and social activities. The BKM, or Badan Keswadayaan Masyarakat, is a representative body elected by the residents of the kelurahan to supervise the UPK in implementing the credit program and other UPP programs. BKM reports to the Camat (head of Sub District) or the Penanggungjawab Operasional Kecamatan (PJOK), the official appointed by the Camat to supervise all UPP activities in the sub district. The BKM coordinates with the Lurah, the head of the kelurahan.

47. For program purposes, the Camat/PJOK reports to the district level Badan Perencanaan Pembangunan Daerah (Bappeda, the local government department for development planning), and the district level Bappeda then reports to the Bappeda at the provincial level. Supervision and coordination functions at all levels of the program are

carried out by consultants based at the district (municipality), regional, and national levels. Some district-based consultants complained that they were pushed to supervise beyond their optimum span of control (in term of distance, frequency, and number of kelurahan covered). However, the study team was not tasked with reviewing the effectiveness of the consultant/supervisory structure.

48. ***Design and Characteristics***. UPP has specific unique characteristics – in terms of basic assumptions on the roles of the community and government, challenges, methodology and implementation, compared to other similar programs of the Government. All activities within UPP are centered on the conviction that poor people are the protagonist of any poverty alleviation program. Members of the community, with the support of the Government, must be involved actively in solving the problems of poverty within their areas. Thus, community's capacity and capability in solving those poverty problems are strategic factors in the preparation and for the sustainability of UPP. The program is implemented under the principles of the universal values of the common good, good governance and sustainable development.

49. UPP provides micro-credits to all members of the society regardless of gender through group lending (on average 10 people per group). It targets specifically those with micro and small businesses in urban areas. The revolving funds from UPP are managed by a financial management unit called UPK and set up within Badan Keswadayaan Masyarakat (Community Empowerment Body; BKM). There is no limitation on the amount of block grants that can be used for micro lending; and their allocation is based entirely on the needs identified during the community development planning process and the three-year village development plan. However, during UPP Phase II and III implementation approximately 30% of block grants were used for micro lending. UPP also provides training to micro-credit groups, such as basic bookkeeping, and technical assistance to UPKs regarding management of the revolving funds.

3.2 PROGRAM REVIEW AND FINDINGS

This study was conducted to 176 beneficiaries of the program, 90 of them were members of KDP and 86 were of UPP. It covered 3 provinces out of 33 provinces in both program UPP and KDP, invoving 9 UPK-KDP out of 2600 subdistricts, 9 UPK-UPP.

3.2.1. Management Structure and Performance

50. ***Legal Status***. Lack of legal status adversely impacts UPK institutional operation and sustainability. In KDP, UPKs serve as the" executing" agent of program micro-credit funds. Their legal status is based on a letter of appointment from Kecamatan (KDP) while in UPP, a notary deed to form Association ("Perkumpulan"). Under both programs, without appropriate legal status, UPK could not get fresh funds from financial institutions and could not mobilize savings, although there are several cases in which UPK of UPP got loans from BPDs.

51. ***Human Resource***. *UPK staff of both KDP and UPP generally have limited experience in managing micro-credit program*. Current human resources management

system for both programs and field staff performance monitoring and evaluation are rudimentary. Field staffs are critical to the quality, success and sustainability of both programs. Key areas for attention in the area of human resource management should include provision of more technical training in micro-credit, performance based-compensation packages as well as establishing performance-based monitoring and evaluation of field staff performance.

52. The challenge in this process is capacity of MAD and BKM in staff selection, hiring and performance monitoring. Based on sample groups, field work revealed instances of high turn-over due to fraud and corruption, related mainly to the lack of control and capacity of the MAD. These kinds of incidents are particularly damaging for programs such as KDP and UPP which rely heavily on public trust.

53. Field staff remuneration and benefits in both KDP and UPP are not uniform and are generally below local average minimum wages (Upah Minimum Rata-rata, UMR). The amount of remuneration and benefits for each field staff is determined by the communities through KDP-MAD and UPP-BKM after reviewing annual cashflow report and proposed budget from UPK and taking into consideration the local/regional minimum wages.

54. UPK office hours under UPP are too limited to provide effective service to the residents of the kelurahan. As a result, accessibility and availability of UPK services to beneficiaries are considered low (i.e. a leader of micro-credit group is not able to visit UPK office to repay loan within the working hours). *A more comprehensive human resource strategy to better serve clients and improve field staff productivity should be considered for future programming*.

55. ***Business planning and budgeting***. UPK's operational and financial guidelines were available. However; strategy to guide the program, to achieve a sustainable future for both KDP and UPP beyond the project period, is not available at UPK's level. Neither program sets clear operational and financial targets nor effectively measures performance against plans. Furthermore, there is no early warning for poor performance or variance deviation. Operational and financial needs are computed based on relatively simple yearly budget allocations based on previous year profit and loss statements, to be approved by MAD (for KDP) and by BKM (for UPP).

56. ***Management Information System (MIS)***. *In some locations, monitoring and control over UPK performance for both KDP and UPP are not efficient because data captured are not timely and accurately available to stakeholders*. MIS. The study found a number of inaccuracies in the information systems. UPP-UPK are not computerized therefore staff must produce forms manually, which has resulted in weaker overall reporting performance. The monthly reporting requirements of KDP are stricter than those of UPP; KDP appears more advanced than UPP in terms of computerized MIS, in which financial reporting has been standardized. For instance, most UPK of KDP in east Java have a sophisticated system that minimizes human errors. There are 15 different forms that must be submitted by UPK-KDP every month, although some of them are not financial reports (as they are not related to the micro-credit program). This is not too many considering that all

the information was required by different stakeholders. However, from our field study, we found out that some forms do not hold correct information, because UPK staff did not fully understand how to fill them.

57. Timely and accurate management information systems are vital to the portfolio management and essential for stakeholders (MAD, BKAD, and BKM) to monitor UPK performance. Most of the time, management were not able to use this information to help them make a decision since they were not available.

58. In the national level, the national consultant has been gathering information from UPK by involving different level facilitators and this has also increased the probability of human errors. Most of the time, current data are not available. A different methodology should be considered, such as UPK directly sending data to the national level.

59. Data back-up procedures in writing do not exist in either of the micro-credit programs. However, having experienced losing data; some did back up their systems.

3.2.2 Services, Clients, and Market

All the findings in this section have been summarized from interviews with 176 members of both programs, 90 of them were KDP members and 86 were UPP. There is no intention to generalize the findings as a national condition. However, these findings here should be taken as aspects to be put into consideration when reviewing any UPK of both PNPM Urban and Rural in the future.

60. ***General profile of the beneficiaries***. In both projects, there is a mix of male and female beneficiaries. In the field surveys, the majority of respondents are female (KDP 90 % and UPP 57%). UPP has no specific targeting program for women, while KDP's programming ensures specific outreach for poor women. In terms of age, the average age for beneficiaries is between 41 and 43.

61. The majority of beneficiaries have an occupation or microbusiness. In KDP, 21.1% of respondent mostly from NTT are unemployed. This is found in female respondents related to SPP programming, where beneficiaries are not required to have a business, but must have demonstrated the ability to repay the loan from some source of income (i.e. spouse, informal activities, etc.). However, this policy leads to low quality of portfolio in NTT in particular.

62. The business sectors for both projects are highly varied, depending on location. In KDP Central Java, the majority of respondents are in trade (36%) and food services (32%). In East Java, 47.4% respondents are engaged in accommodation and food services, while in NTT, 55.2% of respondents are involved in handicrafts. Interestingly, although the target area for KDP is rural, only 11% of respondents report activity in agriculture, livestock and forestry, although this may be related to the location of the surveys.

63. For UPP, most of the respondents are working in trade, except for Central Java, which is led by 36% businesses in agriculture, livestock, and forestry. Low outreach in general to non-trade and agribusinesses may be related to the monthly repayment requirement. Such product parameters effectively bar businesses with more irregular cashflows. Future programming should consider tailoring loan products for specific sectors, depending on the location. Details on respondent profiles can be found in the annexes.

64. ***Products and Services***. Both programs provide basic loan products, based on solidarity group guarantee methodologies. KDP provides two micro-credit products for the poor: loans for productive economic businesses (Kredit Usaha Ekonomi Productif, KUEP) and women's group loans through women's savings and lending groups (Kelompok Simpan Pinjam Perempuan, KSPP); KDP is no longer injecting new funds into UEPs for loans; except for SPP, however the previously injected funds still revolved in kecamatans.

65. UPP offers only a loan product for productive business purposes. UPP has varied requirements and depended very much on each BKM. Up to the moment, UPP is still adding new funds. Largely UPP is funding microentrepreneurs, almost 30% went to risky start-up businesses and a minuscule number to finance agricultural loans.

66. Credit assessment processes for both programs appear adequate to identify beneficiary's household financial capacity to repay the loan. Beneficiary group leaders usually provide all necessary information on their members' credit-worthiness.

Table 9: Loan Product Profiles for KDP and UPP (Based on Sample Groups)

	KECAMATAN DEVELOPMENT PROGRAM	**URBAN POVERTY PROGRAM**
Type of Loan	1. Usaha Ekonomi Produktif (UEP) – *Loan for group for productive economic businesses* 2. Kelompok Simpan Pinjam Perempuan (KSPP) – Multi purpose *Loan for Womens's Savings and Lending Group*	1. evolving fund for productive business (expansion and start-up)
Loan Size to individuals/ Avge loan size	Min Rp 300.000; Max Rp 10.000.000 Average Rp 2.000.000	Min Rp 250,000; Max Rp 1,100,000 Average Rp 575.000
Loan Tenor	Average 12 months (But based on MAD)	Average 10 months (But based on BKM)
Loan Repayment	Monthly	- Monthly - Weekly

	KECAMATAN DEVELOPMENT PROGRAM	URBAN POVERTY PROGRAM
Collateral required to Borrow	Group guarantee.	Group Guarantee.
Interest Rate	15-18 % flat p.a (based on MAD)	12-18 % flat p.a (based on BKM)
Mandatory Savings	Under group name in a bank, passbook held by UPK	Not standardized, mostly save in a group, held by group leader.
Credit Use	1. Micro-business activities 2. Open purpose (for SPP)	Micro-business activities (Start up and running business)

Table 10: KDP Loan Profile

KDP Loan Profile		All	Central Java	East Java	NTT
		90	30	30	30
Loan Size	Min	300,000	800,000	300,000	500,000
	Max	10,000,000	5,000,000	5,000,000	10,000,000
	Average	2,086,667	2,410,000	1,460,000	2,390,000
Loan Installment	Min	31,000	96,000	31,000	50,000
	Max	983,000	491,667	500,000	983,000
	Average	213,612	245,820	152,158	242,858
Loan Term(months)	Min	8	8	12	12
	Max	18	12	12	18
	Average	12	11	12	12

Table 11: UPP Loan Profile

UPP Loan Profile		All	Central Java	East Java	South Sulawesi
		90	30	30	26
Loan Size	Min	250,000	300,000	250,000	300,000
	Max	1,100,000	1,000,000	1,000,000	1,100,000
	Average	574,418	512,000	565,000	615,000
Loan Installment	Min	16,125	34,500	27,500	16,125
	Max	236,500	115,000	115,000	236,500
	Average	69,300	58,600	64,000	87,600
Loan Term(months)	Min	5	10	10	5
	Max	9	12	10	10
	Average	12	10	10	8

67. UPP average loan size is significantly lower than the KDP's, despite its urban focus. Each program shows some variation in loan sizes and terms on a regional basis. Interestingly, although the UPP loan size and product parameters are similar across regions, loan repayment rates are highly varied. In general, both programs charge market interest rates, similar to comparable lending programs in the regions that they serve. Because of the lack of full financial cost information (including all subsidies for regional and national staff) it is impossible to determine whether these interest rates are ultimately sustainable.

68. ***Loan Purpose.*** Strictly following the guidelines of the UPP manual, UPP reached significant numbers of micro-enterprises; even 28% of the total loans went to start-up businesses. A total of 98.2% of UPP beneficiaries reported use of their loans to finance their micro-businesses. In KDP where most respondents are SPP clients with multi-purpose loans as opposed to UPP with micro-business loans, loan use is varied: 63.9% is for micro-business and the rest for other purposes such as education, household consumption or house renovation. Product diversification is important as a trend in microfinance best-practice. *Future programming should consider the relevance of different kinds of loan products to assist families to move permanently out of poverty, particularly in the areas of housing and educational finance.*

69. Interestingly, although 20.7% of KDP NTT respondents have businessea in agriculture, livestock, and forestry, the percentage of loan used for those purposes is zero, because they have other types of business that generate income which would qualify them to get this loan. Details on loan purpose for KDP and UPP can be seen in Tables 10 and 11 below. In both programs, loan usages have achieved the objectives on targeting clients.

Table 12: KDP Loan Purpose

KDP Loan Purpose	All	Central Java	East Java	NTT
	90	30	30	30
Business expansion	63.9%	75.0%	63.4%	55.8%
Children education	17.3%	7.5%	17.1%	25.0%
Consumption (inc.households needs)	9.0%	15.0%	7.3%	5.8%
Agriculture, livestock, fishery	4.5%	0.0%	7.3%	0.0%
To buy assets/durables	1.5%	0.0%	0.0%	3.8%
Saving	1.5%	0.0%	0.0%	3.8%
Business starting capital	0.8%	0.0%	2.4%	0.0%
Self/spouse education	0.8%	2.5%	0.0%	0.0%
Other Loan Repayment	0.8%	0.0%	2.4%	0.0%

Table 13: UPP Loan Purpose

UPP Loan Purpose	All	East Java	Central Java	South Sulawesi
	86	30	30	26
Business (working capital)	68,1 %	50,8%	76,5%	96,2%
Business (starting capital)	27,7 %	49,2%	11,8%	0.0%
Agriculture, livestock, fishery	3, 4 %	0.0%	11,8%	0.0%
Consumption (inc.house hold)	0,8%	0.0%	0.0%	3,8%

70. ***Interest Rate and Collateral***. Interest rates for both micro-credit programs vary between 12 to 18% flat per annum and any changes in interest rate must be approved by MAD (for KDP) and BKM (for UPP). However, this is according to the guideline that interest rate is based on market pricing.

71. Some of the interviewed KDP beneficiary groups (43.3%) reported that they did not provide any form of collateral, while 32.2% said they provided a group guarantee. Meanwhile, 87.2% of respondents receiving loans from UPP said that their loans were

guaranteed by the group, 11.6% by using their family cards (Kartu Keluarga), and 1.2% by using household items. Based on survey findings, it is clear that there is a lack of universal implementation of the solidarity group guarantee mechanism mandated in program planning documents, which may be a leading cause for high delinquency rates in some areas.

72. ***Loan Repayment***. In both KDP and UPP, group leaders play a central role and are responsible in collecting loan repayments from their group members, as well as in monitoring and managing delinquent loans. Loan repayments are usually made on a monthly basis and collected by the group leaders who, in turn, repay UPK on behalf of the group. In KDP, UPK also provides loan repayment pick-up service for the group leaders, particularly those with delinquent loans. The study finds that in some cases the group leaders used their own money in order to pay the loan of another member of the group who cannot meet his/her obligation. As a consequence, group leaders usually prioritize selecting members of his/her group based on repayment capacity and not pro-poor criteria, which is common in solidarity group lending. On the other hand, this may limit the outreach to the poorer clients and a certain strategy is required for reaching the productive poor.

73. Based on survey samples, the majority of program loans are disbursed to the trade sectors, which have high daily cash turnovers. Best practice in Indonesia typically includes more frequent repayment (at least weekly) for this sector in order to ensure higher repayment rates. However, this will pose an administrative challenge for KDP and UPK whose limited human resource capacity and working hours are restricted due to limited staff remuneration and benefits.

74. ***Verification/Credit Analysis***. One of the strengths of the loan process is verification. Although the loan analysis process is not rigorous (not typically required under solidarity group methodology), the verification processes in KDP and UPP are able to identify the characters and capacities of potential clients, with the support of the group leader's information. Loan verifications are usually conducted at a site near the groups for each proposed loan cycle. From the field survey, 91.1 % of KDP respondents and 81.4% of UPP respondents have been assessed by KDP and UPP credit committee prior to the loan disbursement. However, external controls over verification are limited and verification rates tend to decrease with repeat loans, which can compromise loan repayment. The details regarding the loan verification can be found in appendix 11 and 12.

3.2.3. Achieving Objectives

75. ***Objectives***. Both KDP and UPP objectives are clear and program implementation seems to achieve the objectives, particularly on targeting micro- and small-entrepreneurs and helping to improve their access to finance. The challenge to both programs would be to reach more productive poor people. As common to group lending methodology, group leader will select their members based on repayment capacity, thus will not necessarily stay true to the objectives of the programs. Details on KDP and UPP performance are shown in Table 12 and 13 below. Note the high number of programs that are now in the phase-out stage.

76. ***Poverty Targeting/ Site Selection***. Generally, performance on poverty targeting or site selection is strong. The project site selection is based on the poverty data and information from the Central Bureau of Statistics (Biro Pusat Statistik, BPS) and complemented by the data on poverty from the local government. However, not all target locations recommended by the local government's data are finally adopted. Furthermore, outreach to low-income borrowers is strengthened through local poverty mapping and also supported by the low average loan size available (although it is unclear to what extent beneficiaries may borrow from other institutions). Local governments where the programs are implemented are required to financially contribute to the programs' overall budget. Target communities, on the other hand, with the help of program facilitators are asked to provide their own poverty indicators based on their specific conditions. However, the same may not be the case at group level, because the group leader would only choose reliable peers who may not necessarily be the poorest in the area.

Table 14: KDP Performance

KECAMATAN DEVELOPMENT PROGRAM									
NO	LOCATION			OUTREACH AS OF DEC 2007		PROGRAM PERIOD		Project Cash Grant (in Rp 000)	CURRENT STATUS
	District	Sub-district	Population	Group	Borrower	Cycle	Year		
CENTRAL JAVA									
1	Karang Anyar	Karang Anyar	73,120	659	2546	4	2003 - 2007	4,000	Phase Out
2	Karang Anyar	Kebak Kramat	56,702	331	4016	4	2003 - 2007	4,000	Phase Out
3	Grobogan	Grobogan	58,208	262	2850	3	2003 - 2006	3,000	Phase Out
EAST JAVA									
4	Ngawi	Kendal	48,836	112	1383	5	2003, 2005 - 2008	3, 750	KDP Reguler
5	Ponorogo	Siman	NA	28	NA	3	2003 - 2006	2,250	Phase Out
6	Magetan	Panekan	62,996	129	1391	4	2003 - 2006, 2008	3,800	PNPM Generasi
NTT									
7	Ende	Ende Selatan	71,003	247	2053	4	2003 - 2006	3,000	Phase Out
8	Ende	Nangapanda	22,140	146	996	2	2000 - 2003 2006 - 2007	3,964	Phase Out
9	Sikka	Lela	12,284	65	240	4	2003 - 2006	1,500	Phase Out

Table 15: UPP Performance

URBAN POVERTY PROGRAM									
NO	LOCATION			OUTREACH AS OF DEC 2007		PROGRAM PERIOD		Project Cash Grant (in Rp 000)	CURRENT STATUS
	Sub District	Village/Kelurahan	Population	Group	Borrower	Cycle	Year		
CENTRAL JAVA									
1	Banyudono	Denggungan	2,872	48	266	4	2005 - 2007	210	UPP PNPM
2	Teras	Gumokrejo	2,864	46	295	4	2006 - 2007	210	UPP PNPM
3	Sukohardjo	Dukuh	5,330	68	346	3	2005 - 2006	250	Phase Out
EAST JAVA									
4	Ngadiluwih	Tales	8,915	166	872	3	2006 - 2007	450	UPP Reguler
5	Pare	Pare	15,951	58	450	3	2006 - 2007	450	UPP Reguler
6	Jombang	Pulo Lor	8,198	97		4	2005 - 2008	450	UPP Reguler
SOUTH SULAWESI									
7	Barombong	Lembang Parang	5,157	48	384	1	2005 - 2006	77.5	Phase Out
8	Ujung Tanah	Tamalabba	3,169	61	447	1	2005 - 2007	125	UPP Reguler
9	Ujung Tanah	Ujung Tanah	NA	49	NA	1	2006 - 2007	NA	NA

77. ***Program Impact***. *Generally, KDP and UPP are perceived to have positive impacts on the welfare of beneficiaries through improved micro-businesses and education of their children.* Around 77% and 79% of KDP and UPP beneficiaries respectively said that their household income increased upon program participation. Based on this limited survey, the increase in income has been confirmed as a consequence of higher production scale by 59% and 67% of KDP and UPP beneficiaries, respectively. Children's educational levels and beneficiary access to finance are also improving; and unemployment rates are reportedly decreasing (with the exception of Nusatenggara Timur). Complete verification of these impact trends must be based, however, on a full impact study of a larger scale and scope than the present study.

78. *From beneficiaries of both programs, it was revealed that access to financial services is limited and hinges on several key factors, such as availability of financial institutions, affordability of interest rates and the fulfillment of collateral requirements.* KDP and UPP give beneficiaries access to financial services. The majority of the beneficiaries have not had prior access to formal financial institutions, although 20% of KDP and 3.5% of UPP respondents have previously received a loan from other formal financial institutions (mostly in the name of their husbands).

79. KDP client with prior access to financial services reported an average "other" loan size of Rp 7 million while loans from KDP have an average of only Rp Rp 2,086,667 million. Similarly, the average of "other" loan size for UPP clients is Rp 4,100,000 compared to Rp 573.000 from UPP group loans . This indicates that the demand for finance is high and that some program clients are bankable and has access to finance from other institutions. A market survey and product development process could be good initial stages in developing competitive and profitable products for future programming. Clients' graduation and linkage program should also be a consideration for further development. Key competitive advantages for these programs, in the face of local competition, reportedly include simplified procedures and the absence of formal collateral requirement, as well as a strong sense of community ownership and value for the elements of transparency and community participation.

80. Approximately 30% of respondents had accessed informal loans outside of KDP and UPP, mostly from relatives and neighbors. Almost half of KDP and UPP beneficiaries have savings accounts in formal financial institutions, while 24.2% of KDP beneficiaries and 17.9% of UPP's save their money in their respective groups. Based on financial regulations, as an informal financial entity, both KDP and UPP cannot formally mobilize and manage savings. However, savings mobilization is the cornerstone of effective, sustainable microfinance, providing the benefits of cheap local sources of funds and building client loyalty and retention. Detailed information related to beneficiaries' access to finance is shown in the Appendix 11 and 12.

81. District governments stated that there was an increase on tax revenue in areas where UPK in KDP performs well, particularly in East Java. While in a district in South Ende, the chief of UPK stated that they were also able to access the development fund from

the provincial budget (around Rp. 127 million) thanks to the successful implementation of KDP. The fund was used to support the program's revolving fund for the area.

82. ***Beneficiary Satisfaction***. *Most beneficiaries are generally satisfied with both KDP (74.4%) and UPP (91.9%).* Many of them say that they still prefer to get working capital loans from the programs than from other sources, since collateral is not required and the loan application process is simpler. However, some beneficiaries from both programs felt that they still needed to be better-informed on the loan application process and suggested that loan processing time be shortened.

3.2.4. Capacity Building

83. *Capacity building varies depending on budget allocation and capacity of UPKs.* Technical assistance provided through the government's micro-credit programs is still limited, and is typically not conducted regularly. Based on the study, both evaluated programs have technical assistance (i.e., training and consultancy services) for capacity building component in the program implementation. Trainings provided to field staff include financial and operational management, entrepreneurship and micro-credit related subjects. The study finds that most of the KDP and UPP field facilitators have attended an orientation program (i.e., program overview, community development and monitoring and evaluation) and a basic training on micro-credit program (i.e., micro-credit group facilitation, proposal writing, etc.) prior to their field assignments.

84. *Training on specific skills related to micro-credit that is carefully designed and developed for field staff contributes to the success of program implementation.* The study finds that there are specific needs for training on basic microfinance principles, credit assessment techniques, delinquency management and how to manage a proper microcredit program. Capacity building needs to be conducted regularly for both KDP and UPP in order to continuously improve and upgrade staff skills and knowledge. The current trainings given to facilitators were not sufficient in depth and in scope to enable facilitators to train UPKs to be able to run a micro credit unit efficiently.

85. ***Capacity Building for Beneficiaries***. Neither KDP nor UPP has strong performance on the provision of technical assistance for beneficiaries, which is generally limited to group formation, administration and basic book-keeping. There is no clear program direction that relates to technical assistance for end beneficiaries. In limited ways, technical assistance for beneficiaries is provided by UPK staff with the support of local government agencies. Group leaders are trained and are then responsible for providing training for their group members.

86. The types of capacity building requested by respondents vary between locations, both for KDP and UPP. In the KDP Project in Central Java, 35.3% of beneficiaries preferred to have entrepreneurship training to support their business in trading, while NTT reported a 52.4% demand for skills in development training. The difference maybe due to specific business characteristics and local markets. Interestingly, 31.3% of respondents in

East Java felt that they did not need any capacity building due to their busy business and household activities.

87. In the UPP project, business training includes administration, entrepreneurship, marketing and business technical assistance conducted by BKM in collaboration with independent institutes. Based on the field survey findings, entrepreneurship training is most in demand, although many respondents prefer specific practical skills building. Providers for capacity building are varied between locations. In East Java, 88.5% capacity building is provided by independent parties invited by BKM. In Central Java, it is provided by BKM (85.7%) and in South Sulawesi is provided by facilitators together with BKM. These trainings are always government subsidized. Details on capacity building provisions to beneficiaries are shown in Appendix 11 and 12.

3.2.5. Program Implementation

88. ***Group Formation***. *One of the key differences between the two projects is related to solidarity group formation, which is the cornerstone of successful growth and repayment for this lending methodology.* In KDP, the group should be in existence for at least one year, demonstrate competent bookkeeping and experience in group savings and credit. Based on the field survey findings, groups had existed on average for six years. As many as 45.1% of KDP respondents said that groups were formed solely through members' own initiative, while 25.3% were formed by community leaders and 14.3% facilitated by local government agencies. Membership criteria included willingness to take part in the group meetings, being a native community member (identified with copy of identity card), and having an existing business. *Regular group meetings were not consistently enforced throughout the program implementation and were usually held only when there was a loan repayment due.* Details on group formation are shown in the Appendix 11 and 12. In UPP, the potential group beneficiaries should be in existence for at least one year; demonstrate competent bookkeeping and experience in group savings and credit. Based on the field survey findings, groups had existed on average for six years. In all sample areas, UPP respondents said that groups were formed solely through members' own initiative (66.3%), followed by BKM (13.3%), and 12.2% facilitated by community leader. Membership criteria included willingness to take part in the group meetings, local resident (identified with copy of identity card), and having an existing business. *Regular group meetings were mostly conducted in three sample areas (64%). However, based on in-depth interview these meetings were actually not happening regularly. The meetings would be conducted mostly on a monthly basis when there was a loan repayment due.* Details on group formation are shown in the appendix.

89. *The performances of both KDP and UPP loan products and services in meeting clients' demands are generally weak.* Despite a high demand for financial services among beneficiaries, loan product features and services of both micro-credit programs still need to be improved further in order to meet clients' demands. Microfinance best practices suggest that a thorough market survey and new product development process must be done before a new micro-credit product is offered to clients, in order to ensure the marketability and sustainability of the new product.

90. ***Handling Complaints***: Complaints from group members are normally conveyed by group leader during the regular meetings. If the issues cannot be resolved at the group level or village level it is then moved to the district level in the case of KDP. It should be noted that 10.7% of KDP respondents and 63.8% of UPP respondents did not know how complaints should be addressed. In UPP Program, we have found complaint cases only in East Java (92.9%) and South Sulawesi province (10%). However, from only 10% in Sulawest all complaints went directly to BKM. Eventhough it is a small number, it indicates that the beneficiaries trust BKM will be able to solve and/ or forward the issues to the right person.

3.2.6. Portfolio Quality

91. Loan portfolio quality in KDP and UPP is highly variable. Portfolio quality using Portfolio at Risk (PAR) refers in general to the amount of risk of default in the loan portfolio and changes continually as loans are disbursed, payments are made, and payments become due. A high quality portfolio contains a lower amount of risk. The level of risk in the portfolio can be seen from the rate of Portfolio at Risk (PAR) that is calculated by comparing the balance of all outstanding loans that have one or more payments past due to the outstanding portfolio. PAR is considered the most appropriate measure of delinquency.

92. PAR is the recommended ratio for measuring delinquency because it allows us to better see the "hidden beast". The arrears rate or amount Past Due overstates the quality of the portfolio. While the repayment rates measure the percentage of what is paid, or of what was expected to be paid during a given period. As they indicate what the KDP UPK is receiving in payments they are useful in predicting and planning cash-flow in the organization. It is also useful for trend analysis within the organization and can sometimes be used to examine branch and loan officer performance over time. Repayment rates are not a measure of portfolio quality, and the outstanding portfolio is not part of the ration. Therefore it does not tell us anything about the health of the portfolio. International best practice recommended a maximum of 5% PAR as good for microfinance. However, to date Indonesia is still working on the compilation of data from different microfinance units in Indonesia to create a benchmark in the country.

93. Both programs currently utilize ratios and measures which may understate the extent of portfolio quality problems. In KDP, PAR levels vary significantly by geographic location, with East Java having the highest portfolio quality. Meanwhile, in UPP delinquency has been increasing due partly to high fieldstaff turnover and weak delinquency management. The following tables 15 and 16 show program portfolio quality performance, based on existing data. This paragraph especially needs elaboration.

94. Portfolio quality varies highly by region. In NTT, where the highest levels of PAR are reported, the main cause for delinquency is reportedly due to unprofitable investment (86%), which should have been ascertained at the group formation and loan verification stages of the process. If beneficiaries can not repay the loan, 50% of respondents in Central Java would borrow from another institution to repay the KDP loan. This is highly

risky and increases the overall level of indebtedness of the target group. Inability to repay loans must ultimately be attributed to the program's inability to make sound loan decisions. For other locations, the respondents reported rescheduling from UPK when they were late in repayment, which is a highly risky procedure that masks repayment problems.

Table 16: KDP Portfolio Quality

KECAMATAN DEVELOPMENT PROGRAM										
NO	LOCATION		2006				2007			
			ASSET (IN 000)	PORTFOLIO QUALITY		NPL	ASSET (IN 000)	PORTFOLIO QUALITY		NPL
	District	Sub-district		PAR > 30 days	PAR > 365 days			PAR > 30 days	PAR > 365 days	
Central Java										
1	Karang Anyar	Karang Anyar	4,776,630	10.49%	1.44%	6.10%	5,182,198	10.23%	4.40%	19.86%
2	Karang Anyar	Kebak Kramat	4,610,074	9.39%	14.23%	21.60%	4,886,549	8.17%	0.00%	2.35%
3	Grobogan	Grobogan	3,413,391	31.08%	9.68%	22.05%	3,606,846	26.64%	11.40%	18.47%
East Java										
4	Ngawi	Kendal	3,395,428	0.00%	0.00%	1.74%	4,437,482	0.00%	0.00%	7.79%
5	Ponorogo	Siman	2,269,170	14.01%	0.00%	0.00%	2,294,412	0.00%	0.00%	0.00%
6	Magetan	Panekan	4,194,812	12.94%	0.00%	3.37%	5,392,311	2.37%	0.00%	2.37%
NTT										
7	Ende	Ende Selatan	3,073,908	85.12%	22.70%	16.95%	3,106,383	87.76%	55.12%	83.77%
8	Ende	Nangapanda	3,135,581	91.37%	40.32%	63.09%	3,133,018	70.91%	46.04%	56.09%
9	Sikka	Lela	1,531,853	90.99%	63.43%	90.99%	1,525,093	68.67%	56.44%	68.67%

Table 17: UPP Portfolio Quality

URBAN POVERTY PROGRAM										
NO	LOCATION		2006				2007			
			ASSET (IN 000)	PORTFOLIO QUALITY		NPL	ASSET (IN 000)	PORTFOLIO QUALITY		NPL
	Sub District	Village/Kelurahan		PAR > 30 days	PAR > 365 days			PAR > 30 days	PAR > 365 days	
CENTRAL JAVA										
1	Banyudono	Denggungan	60,990	14.67%	0.00%	4.25%	78,854	37.34%	5.30%	17.74%
2	Teras	Gumokrejo	109,921	3.18%	0.00%	0.00%	140,837	23.04%	2.13%	0.00%
3	Sukohardjo	Dukuh	82,754	18.12%	3.99%	5.77%	127,618	22.84%	13.87%	15.57%
EAST JAVA										
4	Ngadiluwih	Tales	110,500	2.83%	0.00%	0.00%	153,478	17.12%	0.00%	1.24%
5	Pare	Pare	139,855	48.27%	0.00%	2.28%	270,486	20.14%	0.00%	2.05%
6	Jombang	Pulo Lor	124,243	22.25%	0.00%	0.00%	146,678	50.21%	0.50%	22.90%
SOUTH SULAWESI										
7	Barombong	Lembang Parang	84,046	28.52%	0.00%	19.20%	102,922	44.22%	2.00%	28.24%
8	Ujung Tanah	Tamalabba	128,702	1.40%	0.00%	0.00%	140,423	29.60%	0.70%	10.40%
9	Ujung Tanah	Ujung Tanah	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a

95. Respondents have minimal understanding of delinquency. Nearly half of the beneficiaries surveyed in some areas did not know what would happen if they failed to repay. The knowledge on delinquency is highest in Central Java with 80% of respondents stating that group guarantees will be used for any late repayment or delinquency.

96. UPP-UPK groups showed more than 20%. PAR >30days. The highest one was in Jombang Subdistrict, Pulo Lor Village in East Java Province (50.21%), followed by Barombong Subdistrict, Lembang Parang Village in South Sulawesi Province (44.22%), and Banyudono Subdistrict, Denggungan Village in Central Java Province (37.34%). For the last two years, most of the UPP-UPK Group showed an increasing trend of portfolio quality deterioration. Only Pare Subdistrict, Pare Village in East Java showed a positive trend in PAR > 30 days, from 48.27% to 20.14%. Some reasons for increasing delinquency were Facilitator turnover; UPK management and minimum law enforcement for the delinquent. In general, the quality of portfolio in both programs were most likely due to the relative maturity of the program and intensive assistance. The study also found that in KDP the first KDP microcredit program on UEP has significantly contributed to the bad quality rating of the portfolio. Since most of them have been in default for more than one year while no action was taken on the recording system, KDP should decide if it wants to keep it there or write it off .

97. ***Reporting Requirements***. *Financial reporting for both KDP and UPK seems to be adequate, but still needs improvement, particularly in relation to loan loss reserves and write-offs.* Moreover, field staffs need to enhance their skills and knowledge on basic accounting and financial reporting system. In KDP, every UPK has to submit 15 different report forms every month to the head of Kecamatan, PJOK, district consultants and inter-village community forum (i.e. balance sheet and income statement, cash-flow, loan repayment, loan collection, inventory, etc.). While in UPP, every UPK is only obliged to submit five different monthly reports (i.e., balance sheet, income statement, loan repayment, cash-flow, and waiting list groups report). The reporting provided by UPK in UPP is considered a basic report, however to be able to cover the future, the reporting system applied by KDP is recommended. This has to be followed by a clear understanding of each purposes of the report forms; how it is being used. The next stage will be how to analyze these reports in order to read the status of the UPK and how to make a decision to achieve sustainability.

98. KDP and UPP financial reporting systems were not well designed to prevent fraud or to promote internal control, as was demonstrated during field surveys. Loan disbursement mechanisms within groups in KDP and UPP were not standardized. Consequently, financial abuse occurred in some provinces (i.e. two cases in NTT under court process and 21 cases in East Java under investigation).

3.2.6. Monitoring and Evaluation

99. To determine the effectiveness of micro-credit programs in alleviating poverty and to establish a clear causality between micro-credit and higher socio-economic welfare, continuous program monitoring and evaluation on data and results is an important prerequisite. While monitoring and evaluation processes for KDP and UPP are relatively strong compared to other government programs in Indonesia, there has been limited impact evaluation on the microcredit front.

100. Monitoring and evaluation were done regularly at all levels of program management, from group level up to the national program coordinator; and results were made public. In KDP, National Management Consultants (NMC) conducted an annual evaluation of UPKs and micro-credit group performance in 2006. At village level, monthly activity reports were easily accessible to public through information bulletin boards.

101. At the group level, UPKs were responsible for monitoring and evaluating group activities and performance, focusing largely on credit assessment and verification, loan disbursement, and loan repayment. UPK together with KDP-TPK and UPP-BKM conducted monitoring and evaluation to groups especially during the verification, disbursement and repayment. Currently, the written documents that can be used as diagnostic tools of the real UPK, group and client situations. are not required on each monitoring visit

102. In survey findings, 72.2% of respondents were monitored regularly during the program, although there was some regional variation. In KDP monitoring was usually conducted by TPK (37.5%) and UPK (35%). While in UPP, it was conducted by UPP-BKM 97.5%. Monitoring was based on informal discussions and observation. Details on program monitoring and evaluation are presented in Appendix 11 and 12.

Internal Control and Audit. *The level of internal control and audit in both KDP and UPP varies and internal control guidelines are not fully adequate*. Audit reports are not easily accessible. In KDP, BPUPK acts as an internal control unit. Members of BPUPK are directly selected from the communities through MAD and serve as volunteers. Internal control skills are limited. KDP in Central Java and East Java were audited by BPKP during the 2004-2006 program implementations; while in NTT audit was conducted by a local supervisory body (Badan Pengawas Daerah, Banwasda).

3.2.7. Program Sustainability

103. ***Sustainability and Exit Strategy for microcredit***. KDP and UPK do not have a clear government exit strategy. Government programming related to micro-credit should always incorporate a long-term "exit strategy" which supports the development of a sustainable source of financing for both micro and small businesses and MFIs. Most of the government officers interviewed said that KDP and UPP were good and effective community-based micro-credit programs. However, the programs' financial sustainability still depends largely on government financing support. Microfinance services provided through the government institutions were often given as one-time microcredits for micro and small business. Loans were largely given to community groups in the form of funds or credits to be revolved to other groups. This system does not effectively support the need of the business for long-term access to repeated sources of finance and other services to be successful.

104. The study found that most of UPKs studied were able to reach operational self-sufficiency (OSS). OSS measures the degree to which operating income covers operating expenses. However, UPKs financial performance still largely depended on government subsidies and has yet to reach financial self-sufficiency to be fully sustainable.

Operational self sufficiency ratio only measures unit capability to cover its operating expenditure, but it would not adjust for cost of fund if the cost of fund was zero as in the case of all UPKs here, because all the funds were government funds, while financial self sufficiency would include the cost of fund if the fund was obtained from commercial institutions or other non-free resources. It is not clear from the program documentation whether UPKs need to continue when the government micro-credit program ends. If they were expected to continue, then they may face this sustainability problem. Table 16 and 17 show the details of KDP and UPP sustainability.

Table 18: KDP Sustainability Ratios

KECAMATAN DEVELOPMENT PROGRAM						
No	LOCATION		2006		2007	
	District	Sub-district	OSS	FSS	OSS	FSS
Central Java						
1	Karang Anyar	Karang Anyar	219.88%	51.52%	207.17%	47.05%
2	Karang Anyar	Kebak Kramat	260.98%	34.04%	203.01%	48.58%
3	Grobogan	Grobogan	308.55%	25.62%	273.22%	27.88%
East Java						
4	Ngawi	Kendal	1122.32%	33.74%	957.69%	39.73%
5	Ponorogo	Siman	146.07%	5.53%	207.81%	10.84%
6	Magetan	Panekan	346.48%	19.55%	699.42%	30.28%
NTT						
7	Ende	Ende Selatan	147.42%	10.60%	96.63%	4.15%
8	Ende	Nangapanda	115.02%	7.48%	120.41%	6.19%
9	Sikka	Lela	94.79%	3.69%	56.87%	3.24%

Table 19: UPP Sustainability Ratios

URBAN POVERTY PROGRAM						
No	LOCATION		2006		2007	
	Sub District	Village/Kelurahan	OSS	FSS	OSS	FSS
CENTRAL JAVA						
1	Banyudono	Denggungan	375.82%	36.11%	254.64%	44.65%
2	Teras	Gumokrejo	NA	NA	NA	NA
3	Sukohardjo	Dukuh	127.88%	26.35%	151.37%	34.11%
EAST JAVA						
4	Ngadiluwih	Tales	3352.92%	44.67%	1137.21%	93.79%
5	Pare	Pare	623.61%	29.90%	497.11%	37.90%
6	Jombang	Pulo Lor	370.85%	12.30%	189.03%	46.54%
SOUTH SULAWESI						
7	Barombong	Lembang Parang	569.10%	41.76%	568.22%	32.55%
8	Ujung Tanah	Tamalabba	120.66%	45.60%	154.25%	48.30%
9	Ujung Tanah	Ujung Tanah	NA	NA	NA	NA

Table 20: Ranking for Selected UPK from KDP Program

KECAMATAN DEVELOPMENT PROGRAM						
Province	LOCATION		PAR	OSS	FSS	Ranking
	District	Sub-district				
East Java	Ngawi	Kendal	0.00%	957.69%	39.73%	1
East Java	Magetan	Panekan	2.37%	699.42%	30.28%	2
Central Java	Karang Anyar	Kebak Kramat	8.17%	203.01%	48.58%	3
East Java	Ponorogo	Siman	0.00%	207.81%	10.84%	4
Central Java	Karang Anyar	Karang Anyar	10.23%	207.17%	47.05%	5
Central Java	Grobogan	Grobogan	26.64%	273.22%	27.88%	6
NTT	Ende	Nangapanda	70.91%	120.41%	6.19%	7
NTT	Sikka	Lela	68.67%	56.87%	3.24%	8
NTT	Ende	Ende Selatan	87.76%	96.63%	4.15%	9

Table 21: Ranking for Selected UPK from UPP Program

URBAN POVERTY PROGRAM						
Province	LOCATION		PAR	OSS	FSS	Ranking
	Subdistrict	Village/Kelurahan				
East Java	Ngadiluwih	Tales	17.12%	1137.12%	93.97%	1
East Java	Pare	Pare	20.14%	497.14%	37.90%	2
Central Java	Teras	Gumukrejo	23.04%	0.00%	49.32%	3
South Sulawesi	Ujung Tanah	Tamalabba	29.60%	154.25%	48.28%	4
Central Java	Banyudono	Dengungan	37.34%	254.64%	44.65%	5
Central Java	Sukoharjo	Dukuh	22.84%	151.37%	34.11%	6
South Sulawesi	Barombong	Lembang Parang	44.22%	568.22%	32.55%	7
East Java	Jombang	Pulo Lor	50.21%	189.03%	46.54%	8
South Sulawesi	Ujung Tanah	Ujung Tanah	n/a	n/a	n/a	9

105. ***Graduation and Linkage***. There was no graduation concept in the project system. Clients' also preferred to stay longer with the UPK for various reasons including the simple procedures and friendly environment.

106. ***Local Government Support***. In general, local governments supported the program implementation. Community active participation was also an important factor to the program sustainability and success. The study found that some local governments even contributed funds to the government micro-credit programs (e.g. Kabupaten Ponorogo in East Java invested a total of IDR 1 billion in two districts and Kabupaten Ende in NTT replicated the program in four other districts).

4. RECOMMENDATIONS ON FUTURE MICROFINANCE PROGRAMMING

4.1 INDONESIAN MODELS

4.1.1 Village-Owned Institutions

107. **Badan Kredit Desa (BKD) and Lembaga Perkreditan Desa (LPD).** These two forms of existing, village-owned microfinance institutions have a long history, dating back nearly 100 years. The LPD system in Bali encompasses nearly 1,200 village-owned institutions which have been acknowledged as an innovative model of village banking globally.4 There are currently over 3,000 BKDs located mainly in Java, although a significant number of the larger BKDs have transformed into BPRs (Bank Perkreditan Rakyat), under pressure from Bank Indonesia to formalize. Success for both of these legal forms is closely linked with population density, and making sure that there is a minimum of 50 active borrowers to ensure that there is sufficient turnover to sustain the funds. The success of the LPD in Bali has also been closely tied to the high level of social cohesion and strength of village governance. Both institutions are owned and managed by a village bureaucracy of some form. LPD in Bali is strongly supported by the provincial government, while BKD in Java receives prudential supervision from BRI, which is an arrangement in decline due to a lack of sustainable financing for the activity. Both forms of institution mobilize public deposits, although the legal underpinnings for these activities are tenuous. Many LPDs and BKDs are effectively linked to the formal financial sector. LPDs have a mandated financial relationship with the Regional Development Bank in Bali (BPD Bali), where they must maintain savings reserves. BKDs are supported and linked to BRI and sometimes also to regional BPR, which provides financing to the BKD occasionally.

4.1.2 SHG/ Bank Linkages

108. Government Projects linking Banks and Self-Help Groups. Indonesia was the first country that translated the concept of linking Self-Help Groups (SHG) with banks into practice. In 1989, Bank Indonesia and GTZ launched a Project to make financial services available to self help groups of farmers and microentrepreneurs. An essential feature of the Indonesian linkage Project was to support sustainable linkages among banks, self-help promotion institutions (SHPI) and SHG. Emphasis was given to savings mobilization by banks and within SHG. Similiarly, the P4K (Proyek Peningkatan Pendapatan Petani dan Nelayan Kecil) is an on-going government Project under the Ministry of Agriculture, which actively forms self-help groups at the village level in rural communities and links them effectively to the formal financial sector, in this case, BRI. The program has been relatively successful in terms of poverty targeting and building sustainable linkages between the groups and banks. However, both programs sufferred when the role of SHPI was phased out. Sustainability was highly variable, depending on the motivation of the partner bank and the viability of the groups.5

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[4] See "ProFI Microfinance Institutional Study", by Detlev Holloh, 2001, for more detailed information on these institutions.

[5] For more information on P4K, see MICRA "Rapid Instituitonal Appraisal of Government Community Based Microfinance Programming" for World Bank and Bapannas, 2007.

4.2 LESSONS LEARNED FROM PRIOR GOVERNMENT PROGRAMMING

109. Over the past year, the MICRA Foundation has reviewed six highly diverse government programs which included a microfinance component. The following is a summary of the key lessons learned and recommendations in relation to the short and long term impact and sustainability of this programming, which hopefully may prove to be useful for the future development of PNPM microfinance efforts.

110. In order to increase program ***impact and sustainability***, government funding for microfinance should always be used as a catalyst for sustainable development. It is also crucial to ***incorporate a long-term "exit strategy"*** that gradually builds commercial partners to assume all the necessary government program activities, and supports the development of a sustainable source of financing for both micro and small-businesses and MFIs. Components to build effective, sustainable linkages with the formal financial system to support growth and leverage government funds should always be included.

111. To the fullest extent possible, ***government agencies should work with and strengthen existing MFIs***, rather than building new MFIs, and whenever possible, support MFIs (and banks) to deliver their own products tailored to the local market, rather than creating temporary "project" products.

112. Government programs that target and ***build the bankability of poor borrowers appear to be a successful intervention*** for building financial access for the poor. However, MFIs should always be allowed to lend based on demonstrated client bankability in order to build the long term viability of the MFI, and therefore its sustainable service for the community. Grant programs for the poor should be administered separately from credit programs.

113. Portfolio quality appears to be higher in areas where ***executing banks played a more active role*** (e.g. Bank Bukopin). The government should take special care in aligning incentives for a meaningful bank participation, as well as in selecting banks with genuine institutional interest in serving the target groups. As much as possible ***identification and participation of executing (or channeling) banks and MFIs*** in the projects must not be by appointment, but rather, through a fair and transparent bidding process.

114. ***On technology application***, an IT model applied by Bank Bukopin that shares data with MFIs on-line is an ideal application of technology to facilitate greater outreach to the poor and ensure transparency in funding provision. Ultimately, this type of shared MIS could form the basis of a credit bureau for low-income borrowers, helping to build their financial track records and ultimately to include them more actively in the formal financial system.

115. Often government loans are mandated for productive, entrepreneurial purposes only. However, limiting loan purposes only for business could limit the benefit of, and access to, credit by the poor. ***The poor also need loans for non-business purposes***, such

as education and housing, in order to protect and build their assets and businesses. Savings products are also extremely important for both poverty alleviation and for building local financial viability.

116. ***Self-Help Groups (SHGs)*** have become a well-known model in the microfinance industry to promote empowerment and access to information, financial services, and livelihood promotion for the poor, especially women. However, in practice SHGs formed over the course of government programming appear dependent on continued external support. That is why many SHGs cease to exist when projects end (P4K). To achieve long-term success, SHGs need to be fully incorporated into MFI or bank activities over the life of the program, rather than supported and subsidized by government field staff.

117. In order to increase ***program quality and outreach***: (i) best-practice rules in SHG formation should be respected and implemented to ensure success of joint-liability group guarantees and performance; (ii) selection of MFIs to participate in government microfinance projects should be ***standardized, objective and performance-based*** to promote a healthy sector development and growth in outreach; (iii) avoid disbursing huge amounts of funding to ill-defined target groups covering the entire country in a short period of time, since this may lead to fraud; (iv) increased transparency in project funding, budgets and performance reporting could drive quality improvement; (v) technical assistance (TA) to participating MFIs is important in increasing outreach, performance and viability; and (vi) micro-insurance products could be incorporated into overall program design to protect both borrowers and MFIs.

118. ***Monitoring and evaluation*** of government microfinance projects have been limited, particularly in relation to impact evaluation. There is very little information, therefore, to drive improved program design. ***A standardized approach to monitoring and evaluating*** program performances based on microfinance best practice would also help create clear guides and support for the overall development of the sector.

119. Field assessments clearly demonstrate a high degree of variation in implementation and performance quality by region. The lack of project controls can lead to fraud. ***Internal controls should be clearly structured into project design*** and linked to monitoring and evaluation, with sufficient budgeting.

120. In order to improve ***program design and implementation***: (i) projects should always clarify the mechanism of grant making and ownership of funds at the end of the project; (ii) participating banks' commitment must be improved through clear directives, incentives and enforcement during project implementation; and (iii) project design should include limited impact and performance measures to monitor quality and inform the design of future programs.

121. In order to focus and improve ***the role of Government***: (i) the Government should play an important role as an enabler, not a direct provider, of financial services, by ensuring sound legal and supervisory systems, as well as capacity building mechanisms for MFIs; and (ii) at the provincial and district levels, the government should build the capacity

of key staff of ministries in best-practice microfinance standards, to allow them to provide competent oversight.

122. The effects of decentralization as well as the ***lack of coordination and local ownership*** of project are some of the critical issues that require attention for successful program implementation. The hand-over of the project from the central to the provincial governments during the transition period often faces many obstacles and should be carefully addressed. Therefore, following decentralization, projects need to be developed in cooperation with local governments to increase local ownership and capacity to implement.

123. A centralized body that specifically oversees and supports these tasks would be very useful to serve as a one-door policy-making body to guide government microfinance programming, helping to align, coordinate, support and more effectively leverage government resources. This body should also be tasked to set standards and coordinate microfinance programming between ministries and to support the development, monitoring and evaluation of microfinance programming at the provincial and district levels.

4.3 INTERNATIONAL MODELS

124. ***Local Government Support***. In general, local governments support the program implementation. The community's active participation is also an important factor to the program's sustainability and success. The study found that some local governments even contributed funds to the government micro-credit programs (e.g. Kabupaten Ponorogo in East Java invested a total of IDR 1 billion in two districts and Kabupaten Ende in NTT replicated the program in four other districts).

125. This study has also reviewed international models that could be implemented or could be adapted to the PNPM model. The study includes five different models for review. All models are sustainable and have allowed for high performing outreach as scale. Three of the models focus on the village banking lending methodology and its implementation, to reflect the state of best practice for institutions working at the village level. Two of the models are at the institutional apex level to demonstrate best practice in work at scale with village banking institutions. The cases were:

- Village banking model: Pro-Mujer
- Village banking model: CRS/MIKRA Bosnia and Herzegovina
- Village banking model: FINCA MicroCredit Company Kyrgyzstan
- Federation of Self-Help Groups India
- World Bank Local Initiatives Project: Bosnia and Herzegovina

126. The field of microfinance is dominated by three major lending methodologies, including individual lending (ex. Alexandria Businessman's Association); solidarity group lending (ex. Grameen Bank), and village banking. Village banking is commonly believed to be the leading methodology in bringing sustainable microfinance services to the very poor in rural areas. Village banking often reaches or specifically targets high numbers of women.

127. Village banking institutions can offer a range of services:

a. Credit—in the form of a loan to a group of approximately 15-30 individuals
b. Savings services—both forced and voluntary
c. Other financial services – such as microinsurance
d. Non-financial services—including skills and empowerment training
e. The internal account—offered by some Village Banking Institutions (VBIs), the internal account provides additional credit, savings, and non-financial services.

128. Village banking (sometimes referred to as community-managed loan funds (CMLF)) is particularly important because it reaches groups in remote or rural areas where there are no other financial service providers. Typically, village banks begin with locally mobilized informal savings. Then, in partnership with a formal institution, they are able to attract capital to supplement their own savings. VBIs typically offer small loans to invest in micro enterprises, helping to create jobs, raise incomes, build assets, and increase families' well-being.

4.3.1. Pro-Mujer

129. One of best global performers in VB is Pro Mujer in Latin America. Pro Mujer, founded in 1990, is a non-profit, international microfinance and women's development network whose mission is to provide Latin America's poorest women with the means to build livelihoods for themselves, and futures for their families through microfinance, business training, and healthcare support. Pro Mujer was originally modeled as a Grameen Bank replication, and has disbursed USD 383 million in small loans since its inception.

130. ***Focusing on Women***. Pro Mujer focus their work on women because they believe that women perform multiple roles, among them child bearing and rearing; home-making, income generating, and community building. Women are seen as a hard working and very responsible. A significant number of Pro Mujer's clients are the sole support of their families. Pro Mujer believes that the empowerment of women is the most effective way to alleviate poverty.

4.3.2. FINCA MicroCredit Company Kyrgyzstan

131. FINCA is a global organization with wholly-owned subsidiaries on four continents, that specializes in village banking financial services. FINCA focuses on building sustainable programs that achieve high standards of financial performance, while retaining a focus on serving the poorest of the working poor. FINCA MicroCredit Company Kyrgyzstan was established in 1995, and now profitably serves over 12,000 villages, including nearly 65,000 people, with 98.9% on time repayment. FINCA MicroCredit Company began as an NGO and recently transformed into a licensed finance company, which accesses commercial funding from local banks and international investors, such as the IFC, to fuel its growth.

4.3.3. CRS Village Banking Model: MIKRA, Bosnia Herzegovina

132. In 1997, MIKRA began operating in Bosnia-Herzegovina, targeting low-income female micro-entrepreneurs through group loans. All of MIKRA's clients were women and they came from every ethnic- and religious groups in Bosnia. They all ran very small businesses, and were unlikely to be able to access loans from banks. This was where MIKRA stepped in.

133. MIKRA has not only been successful at sustaining high repayment rates and reaching large numbers of clients; it has also demonstrated that different ethnic groups can work together. Mikra's clients have formed *zadrugas* that incorporate members of all ethnic and religious groups. They said that working together made them concentrate on improving their businesses and making their *zadruga*s successful, rather than dwelling on ethnic or religious differences.

4.3.4 World Bank Local Initiatives Project: Bosnia Herzegovina

134. The World Bank Local Initiatives Project is a World Bank Project initiated at the end of the conflict in Bosnia and Herzegovina to build a sustainable and vibrant microfinance industry where none had previously existed. This project was recognized as Best Practice in Social Development by the Social Development Family, and received an award for Excellence in Supervision (QSR) from the Quality Assurance Group (QAG).

135. The Bosnia Local Initiatives Project (LIP) sought to overcome social exclusion by targeting groups such as war widows, demobilized soldiers, and other uprooted individuals. In a post-conflict situation, loans are typically earmarked for larger governmental reconstruction projects and rarely for grassroots, or private microcredit. In Bosnia, microfinance proved to be a worthwhile investment as it rapidly created local jobs, which in turn contributed to the rebuilding of the financial infrastructure, particularly for smaller borrowers.

136. The program was initiated with a Pilot Project as a “Greenhouse” for a National Microcredit Project designed to (1) test the demand for microcredit; (2) test different lending methodologies using three different NGOs; and (3) determine whether NGOs have the capacity to manage loan funds. The pilot project tested lending methodologies by using three NGOs that used different lending methodologies: individual, solidarity group and community-managed loan funds /village banking.

137. A competition was held among NGOs and banks to become partner organizations under the project. From about 70 applicants 25 were considered for the “short list" . These applicants were then invited to a “rapid workshop” in which the basics of micro-lending were discussed. Each NGO was required to prepare a proposal for becoming a microcredit partner. The proposals of the NGOs were based on the following criteria:

- Does the applicant understand microcredit?
- Does the organization know its clients and have prior experience with its potential clients?
- Does it know how to target clients?
- Does the organization/ director have a vision?
- Does the organization have the capacity to administer the project?

138. One advantage of the LIP was that the task manager (TM) was based in the field. The TM was able to track changes in attitudes and behaviors of government officials and take advantage of opportunities for adaptive learning to redesign the project and create sustainable institutions.

139. Extensive beneficiary and stakeholder involvement at design and implementation phases enabled the project to benefit from local leadership, experimentation, diversity, and mutual learning. Through the training components, alliances were also built among NGO partners, so that when it came time to downsize the original 17 NGOs to 5, a constructive process ensued that focused on the long-term success of the country's microcredit goals versus the NGOs' short-term ambitions.

140. Transforming a pilot project into a national project required intensive stakeholder involvement at both the local and national levels. These types of coalitions for change need time to grow, but also need to see positive results as a way of mobilizing action for change. The use of a pilot project to initiate and test a national project enabled the team to work productively and quickly outside the bureaucracy of a skeptical government until the success of the pilot project was evident.

4.3.5 Federation of Self Help Group (SHG), India

141. The term Self Help Groups (SHGs) refers to unregistered groups of 10 to 20 members involved primarily in savings and credit activities. The term is often interchangeable with village banks or community-managed loan funds. Over the last decade, cumulatively more than 700,000 Self Help Groups have been formed through the government and other programmings in India, and have gone on to obtain approximately Rs.20 billion (US$425 million) in loans from commercial banks. This has demonstrated the ultimate sustainability and financial viability of SHG in that country.

142. The federation provided:

a. *Economies of Scale*. The SHGs required several essential services that could be provided neither by individual SHGs themselves nor were available on the market at a scale needed by the SHGs. The Federation made sustained availability of these services more likely as it provided the necessary scale at which the services could be offered, and the possibility of it being designed to suit the requirements of the SHGs. Examples of this kind of services were audit and capacity building..

b. *Reduction in Transaction Costs*. The federation offered a level of aggregation that made it financially viable for the companies to deal with this clientele.

c. *Reduction in Delinquency Rates*. The Federation appeared to reduce loan default – both within SHGs as well as from SHGs to banks. In the case of bank loans to SHGs, banks shared information with the federation on a periodic basis, and the federation followed up on defaults.

d. *Providing Value-Added Services*. The Federation provided micro-insurance either on their own or in collaboration with insurance companies.

e. *Reduction of Promotional Cost*. One of key activities and responsibilities of the federation was promotional activity.

f. *Empowerment.* The Federation provided an identity to the SHG members that they were part of a large organization, and built solidarity among the members of different SHGs.

5 FUTURE PROGRAMMING RECOMMENDATIONS

5.1 GENERAL FINDINGS AND RECOMMENDATIONS

143. ***Integrating KDP and UPP***. KDP and UPP have sufficiently significant commonality to warrant integration of their relevant microfinance programming. Commonality includes overall mission, metholdogies, products and community-based approach. Indeed, some overlap between the programs was found during field research, which ultimately affected program quality. Integration would have a wide range of positive results, including improved economies of scale to drive sustainability and innovation, lowered overall administrative costs, and a mix of rural and urban outreach to increase impact, diversification and viability.

144. ***Separation of Microcredit Funds from Other Grant Programming***. Learning from UPP design, it is recommended to separate future microcredit project management from other grant-based activities. The UPK plays a very important role for the success of both programs and should remain a focal point of a unified program. UPK would benefit from intensive technical assistance and development support in new programming.

145. ***"End to End" Program Sustainability***. In order to ensure that the program can achieve its objectives in a sustainable way, UPK program management must be both operationally and financially sustainable at all levels, which includes covering all costs associated with administration and capacity building at all levels. UPK should be authorized to fundraise from other sources, in addition to government funding. UPK staff selection should be driven by demonstrated competency. Operational policies and procedures must be more clearly outlined to promote efficiency and sound operations. Future programming should also clarify the legal status of UPK to avoid potential abuses, build accountability and facilitate sustainable linkages with other financial institutions6.

146. ***Collateral***. One of the major obstacles of poor people to access loans from formal financial institutions is lack of collateral. Therefore, the success of any government's micro-credit program will hinge on the ability of poor beneficiaries to access flexible credit with non-traditional guarantees and also to build assets to support future access to formal finance.

147. ***Poverty targeting and outreach***. Social Mapping approach is a very effective methodology to identify target beneficiaries and to encourage the forming of groups of beneficiaries. Social Mapping is a community-based rural appraisal method to determine the local poverty level and select the target beneficiaries of the program. However, social mapping approach usually requires longer time and highly skilled human resources to implement it. In addition, best-practice rules in group formation should be respected and implemented to ensure success of joint-liability group guarantees and performance.

[6] An example will be LPDs in Bali that are working together with Bali Provincial Development Bank (BPD Bali) and legally formed through the Governor regulation. LPDs can mobilize savings through BPD Bali and use them as the source of fund for micro lending.

148. ***Microinsurance***. There is potential to incorporate microinsurance products into the overall product mix. New "bundled" life and credit insurance product for microfinance institutions have been developed by insurance providers such as Allianz, in cooperation with GTZ ProFI. Such products can prove an important complement to lending, but issues related to moral hazard and overall administration would need to be explored in depth.

149. ***Reaching Women***. Neither KDP nor UPP originally targeted poor women. Later, KDP designed products for womens groups (SPP) which have proven successful overall. Study findings show that despite dedicated targeting, the majority of beneficiaries are women, demonstrating overall success of the basic products in reaching this vulnerable group.

150. ***Islamic Banking***. The application of Islamic banking principles is still relatively new in the microfinance world but a growing trend in Indonesian microfinance. Currently, there are several types of Islamic microfinance institutions in Indonesia such as Bank Perkreditan Rakyat Syariah (BPRS), Baitulmal wat tamwil (BMT) or Baitul Qiradh (BQ) in Aceh. Some government credit lines also specifically focus on Syariah cooperatives as their vehicles for credit delivery.

151. While there have been strong advances in Syariah commercial banking in Indonesia, many MFIs engaged in Syariah lending experience problems with implementing the accurate concept of syariah product often linked to weak technical capacity to develop and administer the relatively complex set of financial products and services. The overall financial infrastructure for Syariah microfinance is still under development, led by key institutions including Bank Indonesia, PNM and the Muamalat Institute, among others. Over the past year, GTZ and MICRA have developed three fundamental courses related to the development, rollout and financial management of Syariah products for MFIs, in an effort to build the state of the practice.

152. Based on this field study of KDP and UPP, it is clear that the majority UPK managers do not have basic knowledge related to Islamic banking and the level of demand for Syariah products among KDP and UPP borrowers is not fully established. However, based on a range of studies over the past two years, there is a fundamental demand for Syariah products in certain geographic areas and for certain groups. Future PNPM programming could include pilot testing of Syariah programming. However, in order to be Syariah compliant, any such programming should function within an overall Syariah framework, which could necessitate splitting off those operations from mainstream credit operations. Any pilot project should include market surveys, close attention to product selection and strong technical assistance for implementers.

5.2 OPTION FOR PROGRAM DESIGN

153. This study has identified five options for the future development of the microcredit programming for KDP and UPP that all include the separation of microfinance

from other grant-based programming, in conformance with historical recommendations related to these programs. These options are briefly outlined below, with the leading recommendation elaborated in more detail in the following section.

5.2.1 Executing Program Credit through Banks

154. This is a common methodology used throughout government credit programming which extends loans to existing self-help groups through commercial banks, often with a supporting government credit guarantee component. The PEMP (Program Pemberdayaan Ekonomi Masyarakat Pesisir) of the Ministry of Marine Affairs and Fisheries is a relatively successful version of this program, which works in cooperation with Bank Bukopin7. The following table outlines the major advantages and disadvantages of this model.

Table 22: Advantage and Disadvantage of Recommended Model 1

Advantage	Disadvantage
Professional delivery of financial services through fully licensed financial intermediary	Disinterested banks leads to poor poverty and geographic outreach, as well as program performance
Ability to graduate some borrowers to other financial products (limited, in practice)	Poor sustainability, if bank not motivated
Ability to utilize technology (ex. Bukopin) to strengthen local provider	Activity often ceases when government subsidies and active support role ends

5.2.2 Linking Community Groups to Banks

155. This approach is generally outlined in section 4.2.2 above, pointing to the examples of BI's successful programming with GTZ ProFI and the P4K (Proyek Peningkatan Pendapatan Petani dan Nelayan Kecil). P4K is on-going government Project under the Ministry of Agriculture which actively forms self-help groups at the village level in rural communities and links them effectively to the formal financial sector, in this case, BRI. The relative advantages and disadvantages of this option are outlined below.

Table 23: Advantage and Disadvantage of Recommended Model 2

Advantages	Disadvantages
Can develop track record for group that leads to expanding commercial credit lines, in high performing programs	Disinterested banks leads to poor service and geographic outreach, as well as program performance
Government loan guarantees	Weak sustainability of local

[7] See MICRA "Rapid Evaluation Report On Government Community Development Operations: *Microfinance and Microcredit Projects" 2007.*

appear successful in some cases in leveraging commercial funding for community groups	community groups requires investment in TA and other activities, which often ends with end of govt subsidy
Poverty targeting of community groups can be good, in bringing unbankable clients to the bank, but can also dissolve over time.	Banks not well prepared to handle credit and perform due diligence, as well as to respond to repayment issues. Easy for banks to abandon scheme (GTZ experience).
Ability to graduate some borrowers to other financial products (limited, in practice) offerred by banks	Often have high end user effective costs/interest rates, as bank and community group costs are included

5.2.3 Devolving Ownership and Management to Village Level

156. This approach is referred to earlier in the report pointing to the examples of the Badan Kredit Desa (BKD) and Lembaga Perkreditan Desa (LPD). These two forms of existing, village-owned microfinance institutions have a long history, dating back nearly 100 years. The LPD system in Bali encompasses nearly 1,200 village-owned institutions which have been acknowledged as an innovative model of village banking globally.8 There are currently over 3,000 BKDs located mainly in Java, although a significant number of the larger BKDs have transformed into BPRs (Bank Perkreditan Rakyat), under pressure from Bank Indonesia to formalize.

157. Success for both of these legal forms is closely linked with population density, and making sure that there is a minimum of 50 active borrowers to ensure that there is sufficient turnover to sustain the funds. The success of the LPD in Bali has also been closely tied to the high level of social cohesion and strength of village governance. Both institutions are owned and managed by a form of village bureaucracy and operated on a part-time basis only, with low fixed and overhead costs. It is clear that the high level of government investment in the LPD, in terms of management capacity building and framework conditions, has had a positive benefit, as LPDs have a much higher level of dynamism that the BKDs, which have not broadly evolved into effective financial intermediaries.

Table 24: Advantages and Disadvantages of Recommended Model 3

Advantage	Disadvantage
Can be a simple solution (BKD), would allow strong performers to explore options such as formalization into a cooperative or BPR, but would	Weak capacity at the village level can lead to increased repayment problems, mismanagement, and lack of ability to expand offerings. Social

[8] See "ProFI Microfinance Institutional Study", by Detlev Holloh, 2001, for more detailed information on these institutions.

likely lead to dissolution of many village funds which lack strong management and other framework conditions	cohesion at the village level can be a critical factor.
Provides village with a foundation to establish financial relationships with other providers who might appear in their local market (BPR, banks, coops, etc.)	Difficulty of issues surrounding legal status, supervision and ongoing technical support. LPDs have been successful also due to intensive investment from provincial government.

5.2.4. Leading formation of village/ kecamatan-owned cooperatives or "BUMDES"

158. When questioned on the desired future direction of their activities, this approach was generally the most highly cited by UPK staff and village leaders at the local level,. MICRA has completed a number of studies in relation to the formation of new cooperatives through government program-related credit lines. The experience with ultimate sustainability of the cooperatives has been extremely variable. Many cooperatives languished and died, while others have formed strong operational links within communities and with institutional partners, including commercial banks (esp. Bank Bukopin). Clearly, a formalization strategy could target only the larger and more financially viable village level programs and would rely heavily on an initial framework of startup support.

Table 25: Advantages and Disadvantages of Recommended Model 4

Advantage	Disadvantage
Many villages have already pursued formalization and are interested in the process	Some villages and district government may not wish to support formalization or may be too small or lack capacity
Local cooperatives could be supported by secondary cooperatives, local government BPR, BPD, commercial banks or others.	As individual cooperatives, with no formal linkages to apex support structure, it may be difficult for local entities to build financial partnerships
Fully supports community self-management goals of project	Weak capacity at the village/kecamatan level can lead to increased repayment problems, mismanagement, lack of ability to expand offerings
Relatively simple solution, but would require significant investment in technical assistance to ensure sustainability	Weak supervision framework for over 35,000 cooperatives has led to a highly fractured and underperforming cooperative sector
Provides village with a foundation to establish financial relationships with other providers who might appear in their local market (BPR, banks, coops, etc.)	BUMDES cannot mobilize savings, which is the cornerstone of sustainability. BUMDES would likely be fully dependent on government budget

5.3. RECOMMENDED PROGRAM DESIGN

5.3.1. Institutionalization of Microfinance Operations

159. The recommended approach to future PNPM programming in relation to microfinance is to consolidate and institutionalize the microfinance fund operations of KDP and UPP, based on a process similar to that outlined in the LIP Bosnia and Herzegovina case presented in 4.1.4 above. In this award-winning World Bank program, delivered in participation with the Ministry of Finance in Bosnia, to build a sustainable and vibrant microfinance industry where none has previously existed. The situation is similar to Indonesia in many ways. Here, the sustainable institutional microfinance infrastructure to administer and develop existing village banks or community-managed loan funds (CMLF) does not exist. However, a potentially strong network of village funds could be linked into professional, microfinance institutions at the regional level to carry on and expand the work of the KDP and UPP facilitators, consultants and UPK staff.

160. PNPM could follow the LIP model of conducting a public tender amongst all institutions deemed potentially qualified to assume the management of regional village CMLF, including BPR, BPD, commercial banks, NGOs, second-tier cooperatives, specialized state-owned entities, etc. Applicants would have to demonstrate their market understanding, sustainable business model, competency in the village banking model and overall business strategy. As the programming densities and performances are highly varied by region, it is recommended that applicants submit proposals at the provincial level or at a multi-province level, which clearly shows their ability to sustainably support the specific markets.

161. PNPM would need to provide a comprehensive support program for the institutions winning the competitive bidding process, which includes:

- Fresh capitalization to invest in village funds which demonstrate a sound performance;
- Operational subsidies to be provided on a declining basis over the first three years, to ensure that institutions are able to build scale and can be expected to cover all costs by the end of year three;
- Technical assistance in village banking operations
- Unified management information system for all institutions, to ensure conformity of reporting, transparency, improved performance and the ability to bring in new or existing institutions should performance fall;
- Possible funds for a legal/ policy program to promote conducive operating environment for village banking.

162. Based on the LIP model in Bosnia, new institutions were provided with clear performance targets related to outreach to the poor, portfolio quality, scale, efficiency and profitability, as well as more qualitative targets related to governance and internal capacity building. If these progressive targets were met over a three to five year period, all funds

placed in the institution would be converted to equity, to ensure the long term operation of fully sustainable, professionally run institutions, serving the poor at scale.

163. In practice there will be a need for a mapping and tender preparation process in order to determine the specification of tender and relevant performance targets. Each province's tender will require its own mapping and preparation following standards set out by the key stakeholders. Mapping should include market and organizational assessment and potential.

164. The following is a presentation of the key advantages and disadvantages linked to this recommendation.

Table 26: Advantages and Disadvantages of Recommended Model 5

Advantages	Disadvantages
Professional management, to include expertise in microfinance, solid framework to support and secure ongoing expertise	Depending on legal form of regional institutions, may or may not allow deposit mobilization, which is the cornerstone of sustainability and effective poverty alleviation
Institutional framework to support the sustainable development and expansion of a program	Depending on legal form of regional institutions, may or may not allow future government channeling (i.e. BPR)
Ability to provide ongoing technical assistance, supervision, audit, MIS	Would require bidding process and start-up support for institutions, as well as incentive-based funding for new regional institution, to include potential capitalization
Ability to inject "fresh funds" from formal financial sector and/ or government	Depending on legal form of regional institutions, may or may not allow effective institutional supervision (BI vs. Ministry of Cooperatives)
Allows villages legal flexibility to participate either as informal CMLF or to participate as formalized cooperatives, etc.	Currently, villages do not pay for services beyond the local administration costs. This would necessitate new arrangements and fee flows to the regional institution to cover its expenses
Ability to link to formal financial sector/ commercial banks to bring in new products, services and funds	Possible confusion and conflict over continued role of local government and change of implementing agency
Allows for institutionalized pro-poor outreach through regular targeting, monitoring and evaluation	Need to develop clear incentives for village participation, to build buy-in essential to long term sustainability and success of model
If successful, would lead to the creation of a sustainable, institutional "exit strategy" for government funding	Risk of low performance by regional institutions would require ongoing PNPM role to monitor and support performance and manage issues over a 5 year timeline

5.3.2. Cost for Micro-credit Program

165. The project budget under the recommended model should cover costs in various levels to convert the revolving fund to a sustainable microfinance beyond program period. PNPM would need to provide a comprehensive support program for the institutions winning the competitive bidding process, to include:

- Fresh capitalization to invest in village funds which demonstrate a sound performance; The size of the micro credit portfolio fund allocated for each location should consider long term institutional sustainability, where the income from loan portfolio should have the capaity to cover the following expenses: operational expenses, cost of fund, inflation, loan loss reserve and institutional capitalization and growth.
- Operational subsidies to be provided to financial institution intermediaries on a declining basis over the first three years, to ensure that institutions could build scale and be expected to cover all costs by the end of year three; the operational subsidies should be calculated based on the result of the mapping conducted

166. However PNPM should cover other costs at the national level to promote a conducive environment to the sustainable model and to ensure conformity of reporting, transparency, improved performance as well as the ability to bring in new or existing institutions should performance fall;

Program level:

- Technical assistance in village banking operations should be provided by the program. Depending on the capacity of the selected financial institution intermediaries, technical assistance can be provided in collaboration with a third party.
- Management information system (MIS) including implementation phase and training.
- Possible funds for a legal/ policy program to promote conduciveness in the operating environment for village banking.

167. Technical assistance should be provided by the program to ensure that the training conducted brings the micro finance unit to the desired level. Profit motives may impede the training deliveries; therefore capacity building should be taken up by the program and not left to the financial institution intermediaries' discretion.

168. A joint cooperation with another financial institution which is a regional market leader would be a perfect collaboration to give the financial institution intermediaries a practical hands-on training and capacity building experience.. However, there are a lot of other players that could provide comprehensive training programs. Another alternative could be partnering with Secondary cooperatives. To teach some standard subjects such as basic accounting and basic computer operations, in partnership with universities would be another good elucidation.

169. It is recommended that the Pilot Phase includes three to five regional institutions. The following is an illustrative budget outlined to cover the administration

phase of a pilot project phase for up to five institutions. In the future, the full budget for a follow-on program should be based on lessons learned from the pilot, as well as projected outreach to existing KDP and UPP villages, as determined by key stakeholders.

170. It is expected that MFIs under the program would be able to leverage portfolio financing by the end of the program at a ratio of 2:1, allowing for ultimate funds available for direct financing of villages to reach USD 7.8 million and more. It is also expected that a strong performance of the pilot would be instrumental in drawing additional private sector funding for the expansion of the program as part of an innovative means to reach this unbanked sector.

171. The total amount needed to start the Pilot Phase for five regional institutions would be around USD 6.53 million. It will consist of the following:

Table 27: Illustrative Budget for Pilot Phase Implementation

ILLUSTRATIVE BUDGET:

Pilot Phase Implementation for Recommended PNPM Strategy (2 YR - in USD)

Internal Staffing	**Units**	**# Units**	**Unit Cost**	**Cost YR 1**	**Cost YR 2**	**TOTAL**
Senior Management (expat)	person	2	160,000	320,000	368,000	688,000
Middle Management (national)	person	5	39,000	195,000	224,250	419,250
Administrative Support (national)	person	3	19,500	58,500	67,275	125,775
				573,500	*659,525*	**1,233,025**
	Assume MFI =		***5***			
Technical Assistance	**Units**	**# Units**	**Unit Cost**	**Cost YR 1**	**Cost YR 2**	**TOTAL**
Consulting	40 days/mfi	5	240,000	264,000	290,400	554,400
Training	training/year	6	168,000	184,800	203,280	388,080
Monitoring and Evaluation	unit/year	1	200,000	220,000	242,000	462,000
Management Information Systems	MFI	5	25,000	125,000		125,000
				668,800	*735,680*	**1,529,480**
Capital to MFIs	**Units**	**# Units**	**Unit Cost**	**Cost YR 1**	**Cost YR 2**	**TOTAL**
Operational grant (yr 1)	MFI	5	150,000	750,000		750,000
Operational grant (yr 2)	MFI	5	100,000		500,000	
On-going capitalization	MFI	5	250,000	1,250,000	1,375,000	2,625,000
				2,000,000	*1,875,000*	**3,375,000**
potential leverage factor of capital (assuming 2 to 1)				*2,500,000*	*2,750,000*	***5,250,000***
Operating Support Costs	**Units**	**# Units**	**Unit Cost**	**Cost YR 1**	**Cost YR 2**	**TOTAL**
Hardware	Staff	10	1,500	15,000	17,250	32,250
Premises	Office	1	36,000	36,000	41,400	77,400
International Travel	Intl Trip	4	5,000	20,000	23,000	43,000
National Travel	National Trip	30	2,000	60,000	69,000	129,000
Meetings and Events	Meeting	4	3,000	12,000	13,800	25,800
Marketing and Publications	unit/year	1	15,000	15,000	17,250	32,250
Other	unit/year	1	24,000	24,000	27,600	51,600
						391,300
TOTAL ESTIMATED EXPENSE				*3,242,300*	*3,270,205*	**6,528,805**
Expected Total Capital to Villages (Assume: 2 to 1 Leverage of Capitalization Funds)						***7,875,000***

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