2nd International Workshop on

Microfinance and Governance

Kristiansand, Norway
31 August – 1 September, 2009

Organized by
The University of Agder and
The Research Group of the European Microfinance Platform

Culture and Governance in Microfinance: Desa Pakraman and Lembaga Perkreditan Desa in Bali

by
Hans Dieter Seibel
University of Cologne

Contents:

28 February 2009

Abstract

Preservation of its cultural and religious identity is a key concern in Bali. Finance is one of the spheres in which that identity has been challenged. Until twenty years ago savings and credit groups (*seka simpan pinjam*) were pervasive, an integral part of the customary community (*banjar*). Yet, as the economy expanded, the demand for financial services exceeded their capacity, and they were unable to compete with the banks. In response the Governor of Bali introduced a new type of financial institution (*LPD*): regulated by provincial law, self-reliant and integrated into Balinese culture. The LPD is owned, managed and governed by the customary village (*desa pakraman*), which is different from the administrative village (*desa dinas*). This has involved a shift in the area of operation of Balinese financial institutions from *banjar* to *desa pakraman*. Within two decades, the LPDs have attained virtually universal and inclusive outreach, replacing the *seka simpan pinjam*. They owe their success to a unique system of governance, integrated into Balinese culture: internal control through a board elected by the indigenous residents (*krama)*, and spiritual control by one's *karma*. This explains the success of the board in inducing delinquents to repay their loans without ever seizing their collateral, even after periods of crisis. However, once governance fails, the agencies in charge of reporting, guidance and supervision, which are not part of the customary cultural system, have not been able to effectively intervene. There is no clear institutional division of labor; in the context of a national decentralization policy resources for reporting and guidance have been placed in the districts, leaving a void at provincial level; the emphasis is on reporting, not on supervision; and none of them has been empowered to enforce standards. External supervision needs to be professionalized, perhaps in a uniquely Balinese way yet to be found.

Culture and Governance in Microfinance

Desa Pakraman and Lembaga Perkreditan Desa in Bali

Hans Dieter Seibel, University of Cologne

1. Introduction[1]

Preservation of its cultural and religious identity is a key concern in Bali. Finance is one of the spheres in which that identity has been challenged. The roots of that identity were planted some 500 years ago by Hindu princes who fled Islamization on Java and established a culture of Dharma Hinduism on Bali, incorporating elements of a preexisting ancient Balinese culture. The result has been an ever-evolving blend of religion and ritual, temple architecture, arts and crafts, music and dance, family life and community associations – a blend characterized by variety and fluidity which nowhere fits into a single fixed pattern.

The 834,000 families of Bali are each registered in one of the administrative villages (*desa dinas*) and component communities (*dusun*); but their social existence is in their own customary communities (*banjar*) and customary villages (*desa adat*, *desa pakraman*), each with its own temples, festivals and ceremonies. Similarly, they may have accounts in one of the commercial or rural banks; but they really live with their own customary financial institutions. This has not been a static relationship, as will be shown in this paper.

Throughout Bali there has been a multitude of savings and credit groups (*seka*) as an integral part of the customary community (*banjar*). Yet, over the past two decades, as the economy expanded, the demand for financial services exceeded their capacity, and they were unable to compete with the banks. In response the Governor of Bali introduced a new type of financial institution, *Lembaga Perkreditan Desa* (*LPD*) – owned, managed and governed by the customary village. This has involved a shift in the area of operation from *banjar* to *desa*.

The LPD has two unique characteristics: (i) as an institution owned and governed by the customary village, it is fully integrated into Balinese culture; (ii) like no other financial institution, it is inclusive in outreach, covering almost all customary villages of Bali and the vast majority of its population. Financing local business from savings, and village temples from profits, has given the customary village a new strength which it did not possess before.

The LPDs owe their success to a unique system of governance: social control through an elected board by the residents, *krama*, and spiritual control by one's *karma*. This explains the success of the board in inducing delinquents to repay their loans without ever seizing their collateral. However, once governance fails, a similarly soft approach has not always worked. External supervision needs to be systematized, perhaps in a uniquely Balinese way yet to be found. This study aims to deepen our understanding of the relationship between culture, governance and institutional performance, as a basis for designing strategies to strengthen a system of local financial institutions integrated into an old culture.

[1] This paper is based on field work in October 2008 as part of a study requested by *Promotion of Small Financial Institutions (ProFI),* a joint project of GTZ, Bank Indonesia and Bank Pembangunan Daerah (BPD) Bali (www.profi.or.id/); their support is gratefully acknowledged. The study has greatly benefited from insights and previous studies by Detlev Holloh (1998, 2000, 2001) and Ketut Nurcahya (2008), both now with ProFI. The three of us worked together in *Pilot Project Linking Banks and Self-help Groups* (*PHBK*), 1988-91, which included Bali.

2. Cultural and religious foundations

Bali is comprised of two systems, distinct and overlapping at the same time. One is secular and part of the overall Indonesian political system: a province headed by a governor and structured into an administrative hierarchy of districts (k*abupaten*), sub-districts (*kecamatan*), administrative villages (*desa dinas*) and communities (*dusun*), each headed by an elected *bupati, camat, kepala desa* and *kepala dusun*, respectively.

The other one is cultural and religious: a Hindu island determined to preserve its identity, headed by the same elected governor who presides over the province, but structured along customary lines of affiliation. The customary system is comprised of customary villages (*desa adat, desa pakraman*) and customary communities (*banjar*), which are only rarely identical with the administrative structure of *desa dinas* and *dusun*. The *desa adat* is a village based on customary law (*adat*), with three village temples, *Kahyangan-Tiga*[2]*,* symbolizing its unity. The Indonesian term *desa adat* is presently being replaced by the Balinese term *desa pakraman*, the village of the *krama*, residents by customary law. The highest authority of the village is the assembly (*paruman desa*) of the customary residents, which elects the village council, *prajuru desa,* and the head of the village, *bendesa*, who presides over the village council. In the execution of his customary duties the *bendesa* is assisted by a secretariat, *peniarikan*.

Most villages are comprised of several *banjar*; but their number may range from one in very small villages to about thirty in large villages. In 2008 there were 1433 customary villages in Bali with 3945 *banjar*, or 2.75 *banjar* per customary village. The basic community in Balinese society is the banjar, which in turn comprises numerous associations. It is headed by a *kelian*, an elected elder presiding over the assembly of the *banjar* residents. The description by Geertz (1959: 994) is still largely valid: "It is responsible for local security, for the legitimation of marriage and divorce and the settlement of inheritance disputes, and for the maintenance of public works such as rural roads, the meeting house, and the local market sheds and cockpit. Commonly it will own a gamelan orchestra and perhaps dancing costumes and masks as well. As in many, but not all parts of Bali, house-land is corporately owned by the bandjar as a whole…. (It) also has significant tax powers. It may fine people… and may even own rice land, purchased out of income, the proceeds of which are also directed to public purposes… (It) also acts as a communal work group for certain ritual purposes, especially for cremations."

The residential society (*banjar*) differs from the irrigation society (*subak*). Accordingly, there are "two sorts of customs, the Balinese say: dry ones for the *bandjar* and wet ones for the *subak*." There is no "straightforward correlation between the place of a person's residence and the location of his rice fields." (Geertz 1967: 212; 235)

The political system of the customary village is a mixture of direct and representative democracy, but ultimately more direct than representative. *Krama* are the residents of the banjar and the customary village. While there is some local variation, there is a basic distinction between *krama ngarep*, the native residents of original descent within the community, with full attendance and voting rights at assemblies; and *krama tamiyu*, "guest" residents without full participation rights. In the *banjar* the *krama ngarep,* usually represented by the heads of household, participate in the monthly *banjar* assemblies (*paruman)* held at the assembly hall, *bale banjar*. In small villages all *krama ngarep* participate in village assemblies (*paruman*). In larger villages, the *krama ngarep* elect their representatives (perwakilan) at the *banjar* assembly, who then form the council of the customary village (*prajuru desa*). Given the fluidity and diversity of Balinese culture, there is

[2] Pura Desa for official village ceremonies, Pura Puseh signifying the origin of the village, and Pura Dalem, the death temple.

some variation between villages in their recognition of *krama* and the rights and privileges attributed to *krama ngarep* and *krama tamiyu*. Depending on the area, *krama* as the banjar assembly may include indigenous household heads, all indigenous married people, or all those who married into the village. However, in all cases, they have to be Balinese; and they have to be Hindu.

The descriptions given above, and those of the LPD given below, have to take into account a fundamental characteristic of Balinese society: its structural fluidity and diversity. There is a small set of basic elements, forming "a compound of social structures, each based on a different principle of social affiliation… (conceptualized) in terms of the intersection of theoretically separable planes of social organization." These comprise shared obligation to worship at a given temple; residence in a banjar; ownership of rice land lying within a single watershed together with membership in an irrigation society (*subak*) which differs from the residential society; commonality of ascribed social status within a title hierarchy; consanguineal and affinal kinship ties; membership in voluntary associations; and legal subordination to a government official. There is almost infinite variety in "the possible forms they can take and the ways in which they can unite with the other elements… the general typological significance of any particular Balinese village lies primarily in its idiosyncracies." (Geertz 1959: 991; 1010-1011) Customary law regulates the appropriate behavior of participants, but not structural forms. There is lies, as we will see, the strength and the weakness of the Balinese LPD.

3. Establishing financial institutions in the customary village

The drop in the price of oil in the early 1980s led to some fundamental changes in financial sector policies in Indonesia: from supply- to demand-leading finance, from financial repression to a market-driven approach, from dominance of government banking to private banking. In June 1983 interest rates were fully deregulated, credit ceilings were eliminated and the supply of liquidity credit was substantially reduced. This resulted in the rise of savings-driven financial institutions and a surge in savings mobilization. In this context, the 3600 rural credit-supply units of government-owned Bank Rakyat Indonesia were transformed into self-reliant microbanking units, one of the most impressive microfinance systems in the developing world (Seibel 1989, 2005). Several provinces, but not Bali, possessed networks of local financial institutions under provincial law, such as LPN in West Sumatra and BKK in Central Java. In Bali savings and credit associations (*seka simpan pinjam*) existed in every banjar; but they were not quite prepared to cope with the demands of a rapidly expanding economy.

Establishing financial institutions at the sub-district level (*kecamatan*) as in Central Java, or at the level of the administrative village (*desa dinas*) as in West Sumatra, was ruled out as these were administrative entities of the national political system without cultural roots in Bali. Two options remained as the operational area for Balinese financial institutions: the *banjar* and the *desa pakraman*. The *banjar* as the basic social and cultural community had numerous social and economic groups and associations, among them the *seka simpan pinjam* or *pecinkreman*, also referred to as the *bank of the banjar*. The *desa pakraman*, comprising anything from one to about thirty *banjar*, possessed no such organizations. Comparing the two entities, the *desa pakraman* appeared more suitable than the *banjar* to guarantee the economies of scale required of a financial institution in a rapidly growing economy.

In an endeavor with a double objective, strengthening Balinese culture and building viable financial institutions, the Governor of Bali, Prof. Dr. Ida Bagus Mantra, took the decision in 1984 to establish local financial institutions – Lembaga Perkreditan Desa (LPDs) – at the level of the *desa pakraman*. 1985-1988 marked the pilot phase. Designed as an integral part of Balinese culture, the LPDs are owned, financed and governed by the customary village and regulated by the Government of Bali. Their explicit purpose is the preservation and strengthening of the customary village with its component *banjar* as the communal space of Balinese economic life, culture and religion. Their unique character within the Indonesian financial landscape is shaped by a combination of several factors: a provincial regulatory framework[3]; a system of self-management and self-governance integrated into the customary village; self-financing through deposit mobilization and retained earnings; and the interdependence of three types of economies: the households with their rice farms, livestock and microenterprises; the customary village; and the LPD. The common bond holding all these spheres together transcends the world of finance and economics: the religious belief in a uniquely Balinese cultural essence which binds together past, present and future lives and permeates all aspects of life.

The LPD functions as a village bank, but is not called a bank because it is not regulated by Bank Indonesia (BI), the central bank. Attempts of converting the LPDs into rural banks (BPR) regulated by BI, as required by the law of October 1988 (*Pakto27*), were resisted. BI could not have supervised large numbers of village-based institutions and would have exerted pressure to consolidate them into larger entities, as it did elsewhere. Finally, in a letter dated Feb 17, 1999, BI recognized LPDs as non-bank financial institutions in Bali.

The number of LPDs increased steadily during the first ten years, reaching 849 in 1995. During the next four years their number stagnated. In 2000 growth resumed, reaching 1356 LPDs as of June 2008, covering 95% of the 1433 customary villages. Borrower and depositor outreach is given below. Statistically, LPD outreach is virtually universal. On average every family, out of a total of 834,000 families (in a population of 3.4 million), holds 1.4 savings and term deposit accounts; and almost every other family (44%) has a loan outstanding. Assuming that every borrower as well as every holder of a term deposit account also holds a savings account, net outreach is 1.12m. (For more detailed information see Annex 1)

Table 1: Borrower and depositor outreach of LPDs, June 2008

Borrower outreach (*number of credit accounts*)		365,044
Depositor outreach (*number of savings & deposit accounts*)		1,204,982
Savings accounts: *Fixed deposit accounts:*	*1,121,994* *82,988*	
Average no of borrowers per LPD		269
Average no of depositors per LPD		889
Borrower-to-depositor ratio		1:3.3

The depth of financial services as of June 2008 is given below: for all LPDs, the average per LPD and the average per client.

Table 2: Depth of financial services of LPDs, June 2008 (in Rupiah and US$)

All LPDs:	Rupiah	US$
Loans outstanding	2.0 trillion	217 million
Savings & fixed deposits	2.4 trillion	261 million
Savings *Fixed deposits*	*1.3 trillion* *1.1 trillion*	*138.8 million* *122.7 million*
Total equity	0.5 trillion	57 million
Average amount per LPD:		
Loans outstanding	1.5 billion	160,000
Savings & fixed deposits	1.8 billion	193,000
Equity	0.4 billion	42,000

[3] The regulatory framework was laid down by Governor Decree No. 972/1984 and finalized, after the pilot phase, by Provincial Government Regulation No. 2/1988, which defined the customary village as the owner and area of operation. Each LPD received a start-up capital amounting to Rp2m (equivalent to US$1780 in 1985).

Average amount per client:		
Loans outstanding	5.5 million	594
Savings & fixed deposits	2.0 million	217
Savings *Fixed deposits*	*1.1 million* *13.6 million*	*$124* *$1,478*

The LPDs are savings-driven; the network is overliquid. The consolidated amount by which deposits have exceeded loans outstanding has increased from Rp42bn in 1999 to Rp411bn as of June 2008. The loan-to-deposit ratio stood at around 83% at the beginning and at the end of the period. Consolidated deposits and total equity together exceeded loans outstanding by Rp118bn in 1999 and by Rp970bn in June 2008, or respectively Rp 129m and Rp715m on average per LPD.

Surplus funds are either deposited in BPD or, to a lesser extent, in other LPDs, while LPDs with a temporary liquidity shortage either borrow from BPD or accept deposits from other LPDs. Interlending is not permitted among LPDs. Deposits in, or from, other LPDs are included on the balance sheet under client transactions. BPD is the only bank authorized by LPD regulation to provide liquidity exchange services to the LPDs. This is not favorable for the LPD, as the balance between interest received from BPD and interest paid to clients is negative.

Growth of the LPDs has been fast, outreach is inclusive, coverage almost total – due to good customary governance. Yet not all is well with the system – due to a lack of effective supervision. Out of a total of 1356 LPDs 228 are not properly functioning; 99 are classified as non-performing, 71 as unsound and 58 as less sound. Of the remaining 1128 LPDs 984 are sound and 144 fairly sound. 88.2% of the portfolio (of all 1356 LPDs) is classified as standard, which means that 11.8% is technically at risk, comprising 6.5% substandard, 3.0% doubtful and 2.3% loss. 83.9% of the clients are classified as standard; the loans of 4.4% are classified as loss.

4. Governance of the LPD: the power of *krama* and *karma*

Owner of the LPD is the customary village. Narrowly interpreted, this has meant in most villages that the original indigenous residents, *krama ngarep*, are the ultimate owners. But whether, and to what extent, other residents, *krama tamiyu*, are included among the owners has not been subjected to legal scrutiny; nor could that be easily done, given the Balinese predilection for fluidity, rather than rigidity, of cultural patterns. As households or individuals do not receive dividends, nor have they been called upon to share losses in case of bankruptcy, the issue has largely remained one of customary perception: in favor of the *krama ngarep*.

Users of the services of the LPD, comprising deposit-taking and the provision of loans as well as payment services in larger LPDs, include several categories of clients as account holders: the original indigenous residents, *krama ngarep;* other residents, *krama tamiyu;* the customary village and the various *banjar* as corporate bodies; *banjar* associations; and savings & credit cooperatives (KSP)[4]. Account holders may be men or women as individuals, household representatives, and formal or informal corporate bodies or associations. Many LPDs strictly follow the regulation and exclude non-residents. Others accept deposits from outsiders, particularly in villages which function as economic centers. Lending to outsiders is

[4] Mostly Koperasi Simpan Pinjam (KSP), established at banjar level, promoted and registered by the Cooperative Authority. Since the deregulation of the cooperative sector in recent years they have spread rapidly in various parts of Bali. Most of the previously private credit unions are now officially registered as KSP. In contrast to most other parts of Indonesia, KSP in Bali perform well.

much rarer, and normally requires a personal guarantee from a resident of the village where the LPD is located.

The management team (*pengurus*) comprises three members, which are appointed by the board: manager, secretary and treasurer. Larger LPDs may have functional divisions, a middle management of division heads and a larger number of staff, like a rural bank. LPD Pecatu, one of the largest LPDs, has 39 employees, all from the village of Pecatu (with a population of 6819 in 2011 families): the usual management team of three; four heads of departments; twenty-eight staff members including deposit and installment collectors; and ancillary staff of four. There is also a credit committee and a unit of internal audit. It is mandatory that management and staff come from the customary village. In some cases such positions are filled by bank retirees originating from the village.

Governance is the duty and priviledge of the customary village, which elects a supervisory board, *pengawas,* from among its *krama ngarep*. The minimum number of board members is three, the maximum rarely exceeds seven. Reputation and competence are the main selection criteria. The board is chaired by the head of the customary village (*bendesa)*. Elections are held every three to five years, depending on the village. In some villages, every *banjar* elects a board member; in others board members are elected by the assembly of the customary village. The board appoints the management, determines the operational terms and procedures of the LPD and has full authority of internal control and enforcement. They routinely meet weekly or monthly as well as in-between as need arises.

Lending authority may be structured differently, depending on the size of an LPD. In smaller LPDs all credit decisions require the approval of the board and the signature of the *bendesa* as the chairman of the board. Loans below a certain amount may be granted by the manager and signed afterwards by the *bendesa*. Large LPDs have a credit committee and a differentiated system of lending authority. Eg, LPD Pecatu has a credit committee of nine, comprising four board members, the management team, the head of the credit department and a credit analyst; lending authority is differentiated: loans up to Rp5m ($500) are decided by the credit department, loans up to Rp25m by the secretary of the LPD, loans up to Rp100m by the management team, and loans above Rp100m up to a ceiling of Rp1.5bn by the credit committee.

Internal control is the responsibility of the board. In the smaller LPDs only the board is involved. In support of the board, large LPDs may establish a unit of internal audit. Eg, in LPD Pecatu, the internal audit unit comprises four board members, plus the head and a specialized support staff of the accounting department; the team meets at least once every two weeks. Auditing is not compulsory; but virtually all big LPDs are audited by a chartered accountant. The regional development bank BPD and district guidance agencies, PLPDK, are involved in monthly reporting of LPDs, but not in formal auditing. It has been suggested by some of the LPDs visited that auditing should be mandatory for LPDs with total assets above Rp5bn ($500,000).

Ultimate authority lies with the village and constituent banjar assemblies as the owner of the LPD. Normally there is close communication between the board, the customary village and the banjar. The *bendesa* as chairman of the board regularly reports to the village council (*prajuru*); the heads of the *banjar*, who are members of the village council, report to the monthly *banjar* assemblies. Board members communicate directly with borrowers in case of delinquency, together with the head of the *banjar* if deemed necessary.

The strength of the LPD lies in its system of governance, which brings together all customary authorities in the village: the *bendesa* as head of the village and at the same time of the board, the other board members, the village administration and the village council, the heads of the *banjar*, and the *banjar* assemblies. Intimate knowledge of all resident families with their past histories and present situations enables the board to arrive at sound credit decisions and to enforce repayment. If necessary the board members involve the other authorities, among them the heads of the *banjar* in particular, to induce loan delinquents to repay. The strongest threat in case of defaulting would be to call the name of the defaulter before the *krama* at the banjar assembly. This would so greatly shame the family of the delinquent that it is rarely, if ever, invoked.

There is yet another, even stronger sanctioning power, which represents the spiritual dimension of governance and does not need to be invoked by any worldly authority: *karma*. Good as well as bad deeds affect a person's *karma*, positively or negatively: in this world, in the beyond and, through reincarnation, in the next life. Saving, investing one's savings or loans to the benefit of the family and repaying one's loans positively impacts one's *karma;* wasting one's resources and failing to settle one's debts has a negative impact. As one of the board members put it: "If you die as a defaulter, you will enter the beyond as a defaulter." It is these two factors, social control by the *krama* and spiritual control by one's *karma,* which explain why the board can be so successful in inducing delinquents to repay their loans and why there are so few LPDs in which physical collateral is ever seized.

5. If governance fails: the role of the board in the fall and rise of an LPD

Paradoxically, the importance of good governance is most evident in those cases where the collaboration between board, management and customary village has broken down; and where the re-establishment of their collaboration has subsequently turned the LPD around. Four case studies are presented below. Three of the case studies deal with past experience and the successful turn-around of an LPD: LPD Kayu Kapas, where an inexperienced board learned only after a crisis what its obligations were, and which is now running smoothly despite its tiny size and remote location; LPD Kapal Mengui, a large LPD brought down by fraud and delinquency after several years of good performance, but brought back to life by a new board with a high level of competence and motivation; and LPD Gelgel, which fell into disarray after ten years and was turned into a model LPD by a committed new governance team including a professional manager. The fourth is LPD Satra, which has been ailing for years, with everyone watching its downfall without taking action: the manager, the old and the new board and the various guidance and supervision agencies, raising serious questions concerning the effectiveness of the system of guidance and supervision.

LPD Kayu Kapas in Bangli district is a tiny LPD which broke down early in its history and could easily have been given up for lack of feasibility. The village, located in a remote area, consists of a single banjar, with 138 families. The manager of the LPD reports that it was established in 2002, even though it is listed by PLPDK as having been licensed in 1997. Bookkeeping is done manually; and there is no telephone connection. The LPD worked reasonably well during the first year, 2003. But the board, comprising three farmers, one of them also a small entrepreneur, was inexperienced and unaware of its responsibilities. Bookkeeping was manual; there was no internal control; nor was external oversight effective. Problems started in 2004, when savers could not withdraw their money, and no new loans were issued. It turned out that the manager of the LPD had used a substantial amount of the funds for his own purposes. As he did not repay, the borrowers also refused to repay. The guidance agency, PLDPK Kintamani, kept visiting the LPD, but was unable to revive the LPD, which became dormant for two years. No records were kept during that period. The turn-around came in May 2007 when the PLPDK invited LPD Batur, a well-functioning neighboring LPD, to instruct the board about its responsibilities and motivate everyone to revitalize the LPD. The bendesa and the manager of the LPD also visited several other LPDs. Without any changes in its composition, the board succeeded convincing the LPD manager and the borrowers to repay their old debts in full. With the help of a six-month loan of Rp3m from LPD Batur, which was repaid on time, it resumed operations. Loan sizes start as low as Rp100,000; the maximum loan size is Rp5m, but there is only one such loan. To minimize the risk of defaulting, the maximum loan period is 10 months.

By December 2007 the LPD had 110 savings and 81 loan accounts from among the 138 families of Kayu Kapas. Total assets amounted to Rp 42.1m, loans outstanding to Rp35.1m, savings to Rp20.0m and net profit to Rp 2.4m. There were no arrears. The LPD was classified as healthy (*sehat*). By August 2008 total assets had increased by 85% to Rp77.8m, loans outstanding had declined to Rp31.1m while Rp20.1m had been deposited in BPD. Savings had soared to Rp52.0m – an increase of 160% and a strong indication of restored confidence. Again, there were no arrears, and the LPD was classified as healthy. Interest income (including income from penalties and fees) amounted to Rp9.4m during the first eight months of the year; salaries of Rp3.35m were the biggest expense item; and net profit amounted to Rp4.6m. Return on average assets was an impressive 7.7%.

The case of LPD Kayu Kapas shows first how a young LPD breaks down if the board is not made aware of its responsibilities. But in a second phase it also shows that, with proper guidance and instruction, a non-functioning board can be turned around, revitalizing a non-performing LPD, restoring confidence, achieving full repayment of arrears despite an extended period during which the LPD was practically closed, and returning to profitability – all this in a very small and remote village normally considered unsuitable for a financial institution of its own. The initiative to revitalize the LPD had come from the PLPDK, but only after a delay of three years. The key instrument used by the PLPDK was the mobilization of both technical and financial assistance by a well-functioning neighboring LPD.

LPD Kapal Mengui in Badung district is one of the larger LPDs in Bali, serving a village of 18 banjar with 2,275 families and a total population of 10,780. Agriculture, livestock, stone crafts and other small enterprises are the main occupations. Established in 1990, the LPD functioned reasonably well for several years, benefiting from the enthusiasm of the start-up phase. Starting in 1994, it ran into a conundrum of problems. Bookkeeping was done manually, which led to errors and eventually to fraud; repayments were not entered into the books. The board did not function properly; and the customary village as owner, spread over a large number of banjar, lacked experience of how to run and control an LPD. The various guidance and external supervision agencies lacked clearly defined tasks and failed to deliver the required technical assistance and oversight. By 1996 the LPD had accumulated losses of Rp75m. In October 1997 elections took place, and a new board of three was installed: the bendesa, a private entrepreneur, and two board members with experience in financial matters. One was the chairman of the local guidance agency, PLPDK; the other one an economist and private entrepreneur who was also a member of a credit cooperative. The village had made the right choice: the new board immediately took action to revitalize the LPD. They mobilized technical assistance from PLDPK and BPD and involved the customary administration of the village and the banjar. They defined the responsibilities of the board members and reintroduced adherence to the regulation. In the words of one of the board members: "We took a social approach, because the problem was in the community, and we addressed the *krama* at the banjar meetings". With strong support from the leadership throughout the community, they succeeded in solving the delinquency problem and recapitalizing the LPD through savings mobilization within a very short period of time. Neither the board members nor the LPD manager accepted any pay for their services; only the staff of the LPD was being paid. By the end of 1997 the LPD turned a profit and has remained profitable ever since. In 2002 the LPD moved to a new building financed by the district government. At the same time it modernized its operations through computerization and adopted an operational handbook of 131 pages, plus annexes.

The LPD now has 8,270 savings & deposit accounts and 843 loan accounts. The total number of management and staff is 22, including 13 collectors. By December 2007 total assets amounted to Rp16.8bn, loans outstanding to Rp 11.7bn. Savings and deposits amounted to Rp 14.85bn. Rp4.2bn in excess liquidity were deposited at BPD. Total equity stood at Rp1.9bn, including Rp0.6bn in profits of the year. Portfolio growth seems to have reached a certain limit, reaching Rp12.3 as of August 2008; savings and deposits stood at

Rp16.9bn. However, its profitability is still growing; at Rp0.6bn, profits by August 2008 the LPD have already attained the amount of the whole of 2007. Loan sizes range from Rp 500,000 to Rp250m; the maximum loan period is 5 years. Yet, the LPD seems to be managing its risks well: defaults, accumulated since inception since there is no write-off, are below 1% of loans outstanding.

The case of LPD Kapal Mengui shows that even in a village with a good potential and after several years of satisfactory performance, an LPD can be brought down through fraud and delinquency if the board doesn't the function, the village with its various customary authorities and bodies doesn't step in and external supervision is ineffective. Manual bookkeeping, inadequate technical skills of the staff and the lack of clearly defined operating procedures facilitated the failure. But the crucial factor was a failure of governance, just as good governance was decisive in bringing the LPD back to life. Once a new board with a high level of competence and motivation was elected, revitalization took place at an amazing speed – several years before computers and new operational procedures were introduced! Assistance from the guidance agency and BPD also played a role, but only after it had been secured upon the initiative of the board. It so happened that the turn-around and subsequent recovery took place at the time of the monetary crisis (*krismon*) of 1997/98 when the banking sector of Indonesia collapsed. LPD Kapal Mengui, like the other LPDs visited, reported no significant negative effects of the crisis.

LPD Gelgel in Klungkung, one of the less development districts of Bali, serves a village of 28 banjar with 2,441 families. Besides agriculture and livestock, there is a multitude of home industries. The LPD was established in 1988 and seems to have functioned reasonably well for about ten years. This changed rather abruptly in 1999 according to the report of the manager: around 80% of the portfolio fell into arrears; losses amounted to Rp0.9m. The downfall of the LPD is attributed to a lack of communication and coordination between management and staff; but it is not clear what led to it. The management did not insist rigorously on repayment; and there were cases of fraud committed by some of the staff. Neither the bendesa nor the other two board members intervened. The initiative to take action came from a member of the village who had retired from a Bank Rakyat Indonesia (BRI) branch and returned home in 2000, at a time when a new board was elected. He first became a board member, in 2000; and as of January 2001 he took over the management of the LPD. At the same time his position on the board was taken over by another former BRI employee, who had retired from a BRI unit. This provided the LPD not only with a new technical competence, but also with an enthusiastic belief in the potential of microbanking.[5] The board took what they called "a family approach to solve the problem of nonperforming loans", attending banjar meetings and convincing defaulters to repay their loans. Involving the bendesa or the head of a banjar is an act of last resort. This has worked very well, eventually everyone repays, sometimes after rescheduling, collateral has never been confiscated – it would be too shameful for all involved. In revamping the LPD the board and the new manager also took a family approach: retaining the staff, insisting on hard work and discipline, introducing good banking practices and tightening the rules. Eg, loans overdue for more than six months were declared bad debts, though not written off; there had been no such rules before. The board also established a close relationship with two well-performing LPDs, which served as role models and acted as consultants and trainers. Loans range from Rp0.5m to Rp500m. 85% of the portfolio is lent for 1-2 years. Two years are the maximum, longer loan periods being considered too risky. 0.3% of the portfolio is overdue, and another 0.3% are classified as bad debts, but are still expected to be recovered.

The board succeeded to restore trust, turning the loss of Rp0.9m of 1999 into a profit of Rp41m in 2000 and Rp125m in 2002. Profits have continued to grow every year, up to

[5] The BRI units are one of the most successful networks of commercial microbanking in the developing world, which came out of the overall banking crisis stronger than before.

Rp515m in 2007.[6] As of August 2008 total assets amounted to Rp13.5bn, loans outstanding to Rp9.7bn, savings and deposits to Rp10.8bn, total equity to Rp1.6bn and profits during the first 8 months of the year to Rp0.37bn. LPD Gelgel is also involved in liquidity exchange with other LPDs in the area. A beautiful new building is under construction, fully financed from its own resources. as a public display of success, next to the market and the *pura desa*, the largest temple of Gelgel.

The case of LPD Gelgel demonstrates how a committed new governance team including a professional manager are able to restore trust and achieve full repayment of overdue loans, using a soft approach without ever taking recourse to the seizing of collateral. As in Kayu Kapas, well-performing LPDs in the area played a supporting role. In contrast to LPD Kapal Mengui, with maximum loan periods of five years, the manager of LPD Gelgel felt that loans for more than two years would be too risky; both LPDs have fared well with their different policies.

LPD Satra in Klungkung district was established in 1986. It is located less than one kilometer from LPD Gelgel. Satra is a village of 4 banjar with 300 families, mostly engaged in farming and handicrafts. The LPD is located in a dark room behind the *bale banjar*. Operations are manual. With total assets of Rp801m as of August 2008, it is only 6% of the size of LPD Gelgel. Loans outstanding amount to Rp623m; Rp 145m are deposited in BPD. Savings and deposits amount to Rp607m. Total equity is Rp195m, including profits of the year of Rp29m. In nominal terms profits increased slightly in recent years (Rp37.0m in 2005, Rp38.3m in 2006 and Rp40.2m in 2007), but declined in real terms. The maximum loan size is Rp25m. The maximum loan period is five years, which is excessive for a small LPD; in fact the three biggest loans (one of Rp25m, two of Rp10m each) are all for 5 years.

LPD Satra is one of 58 LPDs in Bali classified as less sound (*kurang sehat*); it is still making a profit, but facing serious problems, risking further declassification. Only 45% of the portfolio and 35% of the borrowers are classified as standard (*sehat*). 55% of the portfolio is at risk; and two-thirds of the borrowers are defaulters. The difference to the neighboring LPD Gelgel is striking, where less than 1% of the portfolio is at risk, as shown in the table below.

Table 3: Loan portfolio classification in LPD Gelgel and LPD Satra (in percent)

Classification	Amount		Number of borrowers	
	Gelgel	Satra	Gelgel	Satra
Standard	99.3	44.8	92	34.5
Substandard	0.1	30.2	2	20.5
Doubtful	0.2	2.6	2	2
Loss	0.3	22.5	4	43
Total percent	99.9*	100.1*	100	100
Total no of borrowers			832	214
Total in million Rp	9,670	623		

*Error due to rounding

The manager has been with the LPD since its inception. He says he respects the borrowers and does not push them. It is obvious that the previous board has not taken any action. Since January 2008 there is a newly elected *bendesa* and board. But neither has the manager reported the situation to the board, nor has the board visited the LPD to examine the situation, which cannot have remained a secret in a small village like Satra.

[6] Profits amounted to Rp135m in 2003, Rp251m in 2004, Rp325m in 2005 and Rp481m in 2006. In two years, profits stagnated in real terms: 2003, a result of the first Bali bombing on12 Oct 2002; and 2007, which was a difficult year in Indonesia. The Bali bombing of 1 October 2005 does not seem to have had a similar effect..

The LPD is regularly monitored by the guidance agency PLPDK, which also prepares its monthly reports. Yet the PLPDK has not taken action to bring the board and the management together to at least discuss the situation and the steps to be taken; nor have provincial-level support agencies, BPLKDP and BPD, taken action to stop and reverse a situation. Nor has a neighboring LPD been called in for help. Governance has broken down; and external guidance and supervision have remained inactive. A thorough investigation by the guidance and supervision agencies would be in order as a first step, followed by a closely monitored action plan. Yet, some fundamental questions remain: why has no one taken action, who guides the guiding agencies, and who supervises the supervisors?

Two conclusions may be drawn from our case studies, which apply to all LPDs:

- While any LPD risks falling into disarray, a motivated and committed board, whether newly elected or reoriented, can revitalize an LPD within a short period of time, regain the trust of the customary village, apply a soft approach by convincing the defaulters to fully repay their overdue loans, and lead the LPD to continual growth and profitability. The unequivocal conclusion is that good governance, with effective control over management, is absolutely crucial.

- While all LPDs were closely monitored and their poor performance was well known to all agencies involved in guidance and supervision, in none of the cases has instantaneous information been followed by instantaneous action. Adherence, or lack of adherence, to regulation was well documented by monthly reports, but no steps were taken to enforce standards. In two cases the guidance agency PLPDK has played a decisive role in reviving the LPD, but only after considerable delays. In two cases, a strong LPD in the area has given a helping hand; this is an instrument that could be used far more systematically. Province-level agencies have not been involved in the process of revitalization.

6. In support of good governance: the need for effective supervision

Of the 1356 LPDs in Bali, 17% are not properly functioning. Out of ten LPDs visited in 2008, four have undergone a major crisis. Had they been banks like the BPR under the supervision of BI, they would have been closed. There is no information on how many LPDs have lived through similar crises and recovered.

There is a lack of coordination between reporting, guidance and supervision; at the root lies the discrepancy between two administrative systems: (i) the customary system of Bali, which comprises a flat hierarchy of the customary villages at the bottom and the Governor of Bali at the top, who is recognized *like a customary authority*; and (ii) the official administrative system of districts (*kabupaten*), which are headed by an elected *bupati*, to which administrative and budgetary responsibilities have been devolved in the framework of Indonesia's decentralization policy. This has given the *bupati* considerable independence from the provincial government headed by the Governor. It is in his dual capacity as informal head of the customary system and formal head of the official political and administrative system that the Governor of Bali has issued the LPD regulation, which was approved by the parliament of Bali. At the same time resources for reporting and guidance have been allocated to the *bupati*, leaving supervision in a limbo. The effectiveness of supervision and enforcement of regulation hinges upon the practical harmonization of these two systems: the customary system and the decentralized district administration – an unresolved challenge.

Three agencies are involved, paid from a 5% charge on the profits of the LPDs. Pembina LPD Kabupaten (PLPDK) is a network of 16 district guidance agencies, with a total staff of 64, which are in charge of monthly reporting and technical guidance of LPDs. In every district the PLPDK team is embedded into the district administration, but in different departments. This has led to a lack of coordination between the PLPDK teams. Badan Pembina LPD

Kabubaten (BPLPDK) is an LPD guidance board of the district administrative office, which in the past played a leading role in the establishment of new LPDs. It is also mandated to provide guidance in case of operational problems. Bank Pembangunan Daerah (BPD) is a regional development bank owned by the Government of Bali, with branches in each district. With regard to LPD it is given four tasks: (a) acting as an apex bank; (b) consolidation, done manually, of the reports received from the PLPDKs and production of monthly and annual reports; (c) supervision; and (d) guidance. The BPD has allocated one staff member in each branch and an officer in charge at the head office, which is not adequate for effective services. As of 2008 the Governor has placed the PLPDK offices under the authority of the BPD, but has not moved them physically to the BPD branch offices. The effectiveness of this reorganization remains to be seen.

The power of self-organization at the level of the customary village has not been matched by a similar power at the provincial level. The provincial guidance body, PLPDP, placed above the district level PLPDK, has no office, no paid staff and no legal personality and is not structurally involved in reporting and guidance. Its weakness is a reflection of the devolution of power and resources to the district level. There is an informal association of LPDs at the provincial level with representations in various districts, Badan Kerjasama LDP (BKSLPD), but without permanent offices, paid staff or financial contributions from the LPDs. In many countries such associations have taken guidance and interest representation into their hands, in some countries, like Germany, even (*delegated*) supervision and the enforcement of prudential regulation. This potential has not been exploited in Bali.

Reporting is decentralized, involving two organizational systems: the guidance agencies PLPDK and the provincial development bank BPD. 16 PLPDK offices, with a total staff of 64, collect basic data from the LPDs and consolidate them for each of their respective 16 areas of operation. They are not in charge of consolidation at district level, nor is the national body PLPDP involved. The 16 PLPDK offices forward consolidated monthly data in hard copy to the BPD branch in each district. There is no doubt about the reliability of the reported data. However, the validity of the reported data is constrained by two distorting factors: failure to write off bad debts; and failure to exclude non-performing LPDs from financial reports. In sum, despite the effectiveness of regular and reliable reporting, the reporting system has a number of weaknesses which undermine its efficiency and need to be addressed:

- There is no automatic IT-based consolidation, for which the hardware prerequisites are now being created, the required software not yet
- Only consolidated data are passed on in the reporting chain; data on individual LPDs are only stored at PLPDK level; there is no central data base with individual LPD data
- All reports are descriptive; there is no performance and risk analysis of primary data at PLPDK, district or provincial level
- There is no systematic feedback from the reporting system; there is no direct link between reporting and effective supervision, which would include the enforcement of regulatory standards.

Similarly, guidance suffers from a number of deficiencies:

- a lack of coordination of the various institutions involved at the district level, particularly PLPDK/PLPDP, BPLPDK and BPD
- a lack of coordination of the PLPDK teams at the provincial level and the absence of a functioning central PLPDP office with its own budget and permanent staff
- a lack of resources in the BPD branches to provide guidance
- a lack of coordination with supervision.

Supervision, placed in the hands of BPD, is not effective. BPD has focused on consolidated reporting, but has not been able to function as a supervisor. It has not been allocated the necessary financial and the human resources, nor has it been empowered to enforce prudential standards. The ineffectiveness of supervision has led to the following:

- reporting is not used as an instrument in supervision; it has become an end in itself
- the PLPDK teams as quasi-supervisors at field level are unsupervised
- the LPDs are unsupervised, as reported deficiencies do not lead to instant action
- internal control of LPDs and external supervision are not linked
- Only few LPDs use the monthly reports as a management tool.

7. Conclusion

Our overall conclusion is that, while monitoring and reporting are effective, supervision is not. Given the considerable number of LPDs which are not in good health, it has to be assumed that on principle all LPDs are at risk and require a system of effective supervision and immediate action at the first sign of weakness. There is no coordination among the various agencies, and there are no instruments of enforcement of regulation. The soft approach of the customary village works well under conditions of good governance. But in the absence of higher level customary institutions, once governance fails, a similarly soft approach to supervision has not worked.

The policymaker in Bali may learn two fundamental lessons from the sub-prime crisis in the United States: (i) failure to supervise financial institutions effectively and to enforce regulatory standards will inevitably lead to major problems if not a systemic crisis, which in the extreme may be beyond the capacity of the policymaker and supervisor to resolve; (ii) effective supervision is a never-ending challenge.

References

Geertz, Clifford, 1959:. “Form and Variation in Balinese Village Structure.” *American Anthropologist,* 61: 991-1012

-, 1967: Tihingan: A Balinese Village. Pp. 209-243 in: Koentjaraningrate. ed., Villages in Indonesia. New York, Cornell University Press

-, 1983: Local Knowledge: Further Essays in Interpretive Anthropology. New York, Basic Books

Holloh, Detlev, 1998: Microfinance in Indonesia: Between State, Market and Self-Organization. Hamburg, LIT Verlag

-, 2000: ProFI Baseline Survey: LPD - Lembaga Perkreditan Desa. Jakarta, Bank Indonesia & GTZ/ProFI

-, 2001: Microfinance Institutions Study, Indonesia. Jakarta, Bank Indonesia & GTZ/ProFI

Misra, Rewa, 2008: Muntigunung Lembaga Perkreditan Desa, Indonesia: Village Ownership as a Model for Remote Outreach of Financial Services. In: Reaching the Hard to Reach: Comparative Study of Member-Owned Financial Institutions in Remote Rural Areas. Antigonish, COADY International Institute, St. Francis Xavier University

Nurcahya, Ketut, 2008: Lembaga Perkreditan Desa in Bali: A Sustainable System of Village Credit Institutions. Presentation, European Microfinance Week, Luxembourg, www.e-mfp.eu

Seibel, H. D., 2005: Bank Rakyat Indonesia: A Flagship of Rural Microfinance in Asia. Pp. 7-20 in: Malcolm Harper & Sukhwinder S. Arora, eds., Small Customers, Big Market: Commercial Banks in Microfinance. ITDG Publishing, Bourton-on-Dunsmore (UK) & TERI Press, New Delhi

Annex 1: Basic LPD data, 1999-June 2008

Amounts in million Rupiah:	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**Jun-08**
No of desa adat	1371	1371	1380	1392	1407	1423	1414	1415	1433	1433
No of licensed LPDs	912	926	953	1152	1208	1289	1304	1328	1351	1356
No of borrowers	204,842	218,632	233,990	270,321	301,328	317,293	333,798	352,602	359,507	365,044
Average no borrowers per LPD	225	236	246	235	249	246	256	266	266	269
Average loan outst'g per LPD	237	383	537	554	628	750	968	1126	1309	1469
Av. loan outst'g per borrower	1.1	1.6	2.2	2.4	2.5	3.0	3.8	4.2	4.9	5.5
No of savers & depositors	611,531	676,780	743,636	826,639	885,325	967,552	1,021,799	1,092,332	1,193,469	1,204,982
Av. no per LPD	671	731	780	718	733	751	784	823	883	889
Av. deposits per LPD	283	424	567	547	674	866	1032	1151	1515	1772
Av. deposits per depositor	0.4	0.6	0.7	0.8	0.9	1.2	1.3	1.4	1.7	2.0
Total assets per LPD	371	541	730	730	889	1,114	1,337	1,514	1,938	2,217
Total equity per LPD	83	110	150	168	199	232	285	339	396	412

Amounts in US$:	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**Jun-08**
Average loan out'g per LPD	33,323	39,965	51,667	61,968	74,595	80,751	98,455	119,929	138,997	159,864
Av. loan outst'g per borrower	148	169	210	264	299	328	385	452	522	594
Av. deposits per LPD	39,858	44,197	54,497	61,192	80,022	93,290	104,972	122,543	160,827	192,841
Av. deposits per depositor	59	60	70	85	109	124	134	149	182	217
US$ exchange rate	7100	9595	10400	8940	8425	9285	9830	9393	9419	9189

Balance sheet, in billion Rp.	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**Jun-08**
Cash	8.4	18.0	19.2	21.3	32.9	35.4	39.4	51.7	65.0	66.5
Deposits in banks	111.2	122.2	156.0	166.7	259.5	406.6	406.9	416.4	720.5	864.6
Gross loans outstanding	215.8	355.1	512.1	638.2	759.2	966.5	1262.0	1496.0	1768.7	1992.0
Loan loss reserve	-4.7	-6.1	-8.9	-12.5	-15.5	-20.9	-27.2	-33.7	-41.1	-43.6
Net fixed and other assets	7.9	11.6	17.1	27.2	37.4	49.0	62.0	80.8	105.2	126.4
Total Assets	338.7	500.8	695.6	840.9	1073.4	1436.5	1743.1	2011.2	2618.3	3005.9
Client savings & deposits	258.1	392.7	540.1	630.2	814.4	1116.5	1345.6	1528.6	2046.5	2402.9
Borrowings & other liabilities	5.3	6.5	12.2	17.1	18.6	21.1	25.9	33.0	36.1	44.2
Equity (incl. profit of the year)	75.3	101.6	143.3	193.7	240.4	298.9	371.6	449.6	535.7	558.8
Total Liabilities	338.7	500.8	695.6	840.9	1073.4	1436.5	1743.1	2011.2	2618.3	3005.9
Profit of the year	27.1	36.6	54.4	66.9	71.0	85.0	106.3	118.8	131.1	77.5
Total assets in million US$	47.7	52.2	66.9	94.1	127.4	154.7	177.3	214.1	278.0	327.1
CAR (*excl. profit of the year*)	14.2	13.0	12.8	15.1	15.8	14.9	15.2	16.4	15.4	16.0
Return on average assets		8.7	9.1	8.7	7.4	6.8	6.7	6.3	5.7	